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U.S. Department of Housing and Urban Development
Office of Policy Development and Research

Volume III: Alternatives to RESPA

Real Estate Closing Costs

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REAL ESTATE CLOSING COSTS

RESPA, Section 14a

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Volume III
Alternatives To RESPA

October 1980

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I. INTRODUCTION

The settlement service markets examined in this study demonstrate several common characteristics that should be evaluated in any consideration for intervention. These characteristics may not be present for each settlement service, but they are widespread and have a significant influence on overall market performance. These characteristics are as follows:

- Consumers have limited information about products, providers and prices.
- Direct shopping for settlement services is limited.
- Direct consumer access to insurance providers is limited.
- Providers compete primarily for referrals rather than directly for consumers' business, i.e., reverse competition.
- Providers tend to compete through non-price competition (product differentiation, additional services, etc.) rather than through active price competition.
- Certain factors (other than reverse competition) are present which tend to discourage price competition:
  - vestiges of established and generally accepted industry-wide rate schedules;
  - inconsistent state rate regulation; and
  - cooperative agreements among providers.
- The presence of tied relationships, lack of adequate consumer information, or lack of direct competition for consumers.

This listing is not intended to create an impression that excessive prices, poor quality, or inappropriate services are prevalent in settlement markets throughout the country. Rather, such conditions are presented as deviations from the ideal: a market characterized by active price competition in which providers are responsive to the needs and informed demands of consumers. In fact, these observed characteristics of settlement service markets result in: (1) the consumer in many localities paying higher costs than necessary for settlement services; and (2) the requirement in some cases for services that are inappropriate or excessive. The alternatives developed in this study present a range of actions designed to remedy these characteristics of market performance. They include: (1) alternatives advanced over the past ten years by students and practitioners of the industry; and (2) variations we have considered that might improve or correct inefficient market performance.

The consideration of alternatives to RESPA that were mandated in this study has as its principal objectives, the improvement in price competition in settlement services. We have found that significant forms of non-price competition exist among the settlement providers. Many of these provide indirect benefits to sellers and buyers of homes. The remainder of this volume, however, deals only with alternatives intended to improve or encourage price competition. We have attempted to evaluate these alternatives in terms of their anticipated efficacy in increasing price competition; our evaluation also addresses the expected "downside" effects, such as difficulties of implementation and the disruptive aspects of these alternatives.

METHODOLOGY FOR DEVELOPING AND EVALUATING ALTERNATIVES

Clearly, the first task in developing alternatives for policy intervention is to identify the principal objectives of any intervention involving market practices. Because some objectives may hinder or even be inconsistent with others, it is also important to establish an order of priority. The potential list of objectives for policy intervention include the following:

- Reduce settlement costs;
- Ensure that only appropriate services are provided;
- Eliminate settlement processes which tend to raise charges;
- Provide consumers with easier access to relevant information about settlement services; and
- Reduce financial barriers to home ownership by lowering costs required at settlement.

The highest priority has been given to reducing settlement costs where they are found to be excessive. However, it is also important to ensure that services are responsive to the requirements of consumers and are not in excess of their needs or the legitimate needs of providers. As discussed throughout this study, both (1) the complexity and highly technical nature of settlement services, and (2) the narrow experience of most home buyers, contribute to the inadequacy of current levels of consumer information describing settlement services. The consumer potentially may be led into buying inappropriate or excessive services. As enacted, RESPA is intended to educate the consumer so that he will obtain only needed settlement services at minimum cost.

The process by which consumers gain convenient access to relevant information should contribute, in theory, to lower costs and to the provision of only appropriate settlement services. This process is, itself, an important objective. However, many would argue that public policy must only provide the consumer with the tools necessary to make intelligent decisions in a well functioning market, and that public policy need not be concerned with whether he makes the right decisions. Access to adequate information thus becomes an end in itself, rather than just an improvement in a process designed to achieve certain objectives.

Access to relevant consumer information is important for another reason: efficient and well functioning markets that are responsive to consumer concerns are not possible without informed consumers. Such access can therefore be considered an essential precondition for workable competition and for good performance in the settlement service markets.

HUD has long been concerned with reducing economic barriers to home ownership, and a decrease in those costs required at settlement may enable some cash-short consumers to become home owners. While this goal may be important, there is little in RESPA's legislative history to suggest that a reduction in settlement costs by means of a deferral of those costs into higher subsequent monthly payments, might be an explicit goal of the program. Therefore, while we recognize that it is desirable to reduce economic barriers to home owners, we do not consider this a primary objective of either RESPA or of any of the analyzed alternatives.

THE NEED TO EVALUATE ADVANTAGES, DISADVANTAGES AND RISKS

The process of evaluating alternatives includes a discussion of both their advantages and disadvantages. As many parties may be affected by policy and regulatory interventions, it is important both to identify them and to explain the nature of the impact. In order to provide some perspective as to the dimensions of both the problems and the proposed interventions, the dollar magnitude of both current costs and potential savings is sometimes estimated.

There is some risk that the alternatives evaluated will not work as planned. Some proposed alternatives involve substantial changes in the process of providing settlement services. For this reason, it is important to determine whether the intervention is reversible; that is, if it is tried and does not work, can the status quo be reestablished? This question is addressed specifically for those alternatives which involve major changes in the settlement process.

Each alternative is considered separately and not in tandem. Clearly, many may be mutually compatable and may be assembled into a package. However, there are some that are mutually exclusive or cannot be implemented concurrently. In any case, we have attempted to construct no "best combination," Each alternative is considered separately and not in tandem. Clearly most can be assembled into a package. However, there are some that are mutually exclusive or cannot be implemented concurrently. In any case, we have not attempted to construct a "best combination," since that was beyond our charge. If combinations of alternatives are contemplated, then the stated advantages, disadvantages, and evaluations we have included singly would have to be reconstructed for the combination to be sure that the combined effects are not other than the sum of the parts.

MAJOR APPROACHES TO ALTERNATIVES

There are at least four primary approaches to the alternatives we consider. That is, the alternatives can be grouped according to the basic premises on which they rest. Before the alternatives are evaluated, it is useful to examine these approaches briefly.

Approaches Which Seek to Improve Competitiveness and Performance of Individual Settlement Provider Markets

The basic premise for this approach is that there are significant problems in the settlement service markets, but that performance can be improved through efforts to change practices within those markets. This may be considered the main-line approach; it is consistent with the intent of RESPA to seek to promote better informed consumers and to eliminate abuses which impede good market performance. Alternatives in this category are considered which tend to strengthen active price competition within individual settlement markets. Removal of barriers to active price competition, such as rate regulation, provider adherence to industry-wide price schedules, and informal understandings among providers regarding maintenance of current price structures, are fully consistent with this approach.

Approaches Which Seek to Lower Charges Through Direct Regulation of Settlement Prices and Practices

This approach assumes that market performance is poor and that not much can be done to improve it. Its proponents may include those who have little faith that economic markets can perform efficiently and those who believe that the conditions which foster reverse competition are so intractable that without direct regulation, improvement is hopeless. Proposals consistent with this approach are strengthened regulation of settlement service pricing and, in an extreme case, regulation of services as to how and by whom they are provided.

Approaches Which Seek a Minimal Regulatory Involvement in Settlement Markets

Proponents of this approach may include those who believe that problems in the industry are not very significant or that if they are, there is little anyone can do about them without onerous and costly regulatory activity. They are united in believing that regulation and government involvement in economic markets impose costs on providers and tend to make things worse rather than better. Proponents may believe that RESPA has failed and its provisions should be suspended (or the act repealed), or that industry has learned to live with it and it should not be substantially modified.

Approaches Which Package Settlement Services at Most Competitive Point

Proponents of this approach, like those of the second, believe that market performance is poor but that little can be done within individual markets to improve it; imperfections in individual settlement markets are so severe and unyielding to change that reasonable settlement costs cannot be achieved without major structual change. Yet, they believe in the capability of the marketplace to produce more acceptable results when compared to other attempts at regulation. Advocates of service packaging suggest that the market service with the greatest potential price competition be identified and require providers in that market segment to provide or arrange for the provision of other settlement services. They believe that providers in that market segment, reacting to intense competitive pressures, will be forced to seek out the least costly, most efficient way of supplying settlement services or suffer losing market share to their competitors. Lender-pay is the purest form of this approach.

This discussion is somewhat simplistic in seeking to classify alternatives into discrete, mutually exclusive categories. In the real world there could be some blending and overlap. Yet most of the alternatives considered here can be identified as falling primarily within one of these four categories.

OVERVIEW OF VOLUME III

This volume addresses alternatives to RESPA. It is organized along three separate, though not mutually exclusive, themes. Chapter II considers alternatives which evaluate the extent to which RESPA has fulfilled its purpose and which represent courses of action designed to improve the availability of consumer information and encourage comparison shopping. Chapter III addresses alternatives that are specifically designed to reduce the cost of each individual settlement service. There are four sections to this chapter, which consider alterations to the brokerage, mortgage lending, mortgage insurance, and title assurance industries.

Finally, Chapter IV presents a broad discussion of the relative merits of the lender-pay alternative. This alternative represents the fourth approach to designing an effective mechanism for reducing settlement costs.

II. ALTERNATIVES TO IMPROVE THE AVAILABILITY OF CONSUMER INFORMATION AND ENCOURAGE SHOPPING

This chapter and the two that follow consider policy intervention alternatives from three very distinct perspectives. The first considers alternatives or improvements to the existing regulations that will better achieve the first purpose of the act that is defined in Section 2(b)(1) as "more effective advance disclosure" for both buyers and sellers. Chapters XIII through XV of Volume II describe the current effects of RESPA as follows:

- Complete compliance with RESPA has not occurred;
- Consumers shop only minimally for real estate services (about one out of ten home buyers appear to be induced to shop as a result of RESPA); and
- Little decline in overall settlement costs can be attributed to RESPA.

This chapter, then, considers alternatives to improving current legislation so as to increase consumer information and encourage shopping. A number of specific changes to the Act are projected in the process. Three possible alternatives are outlined and evaluated as follows.

ALTERNATIVE 1: REPEAL RESPA

The repeal of RESPA would be justified if: (1) only marginal consumer shopping could be attributed to it; (2) it were ineffective in achieving an overall reduction in settlement costs; and (3) the economic costs of repeal did not outweigh these costs of allowing the Act to remain in effect. We conclude that repeal of RESPA is unjustified in terms of all three of these tests.

Impact Upon Shopping

Our survey of home buyers indicates that RESPA, through the distribution of the Special Information Booklet and the provision of the good faith estimate (GFE), has had only about a 9.2 percent success rate in stimulating home buyers to shop for settlement service providers. Although this rate is low, we feel that it is a very conservative one. As Chapter XIV of Volume II suggests, it does not reflect the number of home buyers who may have been encouraged by RESPA to shop for providers when purchasing an earlier home, and this rate does not represent those home buyers stimulated to shop by some manifestation of RESPA other than the SIB or the GFE. The enactment of RESPA represented a significant step in defense of consumer interests relating to home purchases, and it has been accompanied by a wealth of indirect consumer information through newspapers and other media that have expanded consumer awareness and stimulated overall shopping. As a result, we feel that the extent of effective shopping that our study can attribute to the distribution of the SIB substantially understates the true level of shopping that has resulted from RESPA. On the whole, RESPA has positively achieved its purpose of more effective advance disclosure.

Impact Upon Cost

We did not specifically identify whether shopping (resulting from RESPA) achieved greater financial benefits for home buyers in the form of lower settlement costs. Chapter XV of Volume II describes real prices for title assurance and conveyancing costs as probably declining between 1975 and 1979. This may suggest a move toward greater price competitiveness in title-related services in the four cities studied, but we are unable to specifically attribute relative declines in settlement costs to RESPA. Is this adequate information to suggest that RESPA has not achieved an overall reduction in settlement costs? We think not, for a number of reasons.

First, RESPA has created a more cautious and, at times, defensive environment surrounding: (1) the leading to; (2) the recommending of; and (3) the requiring of settlement service providers. Both Sections 8 and 9 of the Act have specifically influenced the methods of referring or requiring services. Although they have been only marginally enforced, they have required changes regarding questionable practices that earlier were tolerated. Although specific evidence does not allow us to conclude that these changes in practices have led to less costly settlement services, practice considerations strongly suggest that they have.

Second, to the extent that significant differences in the prices of alternative settlement service providers have occurred and to the extent that RESPA precipitated more knowledgeable consumers and a higher frequency of shopping, home buyers have been able to secure lower prices. Though we cannot logically conclude that shopping alone results in lower settlement costs, evidence presented in Chapters IX through XII of Volume II has demonstrated that some price variability does exist within local markets, particularly with regard to the costs of finance and title assurance and conveyancing services. It thus appears that RESPA may have contributed to conditions that allow less expensive settlement costs to be realized.

Economic Cost of Repeal

Even if no increase in shopping and no decline in overall settlement costs could be attributed to RESPA, its repeal would be unjustified if the total economic costs of such an action would not be outweighed by its benefits. Mortgage lenders have borne the primary burden of responsibility for performance under RESPA. Throughout our interviews with both primary lenders and their trade groups (at both the state and national level), they indicated that although the requirements of RESPA have been difficult and at times costly to comply with, it would be equally difficult to change or repeal RESPA and mandate a new set of procedures.

This reasoning strongly suggests that the repeal of RESPA is less desirable than maintenance of the status quo. This sentiment is further supported by the belief by some that to repeal RESPA would encourage the re-initiation of some abusive practices and would result in additional costs--both financial in terms of higher costs to consumer and economic in terms of less efficient activities--that would outweigh the current, marginal costs of compliance by lenders. Although it cannot convincingly be demonstrated that RESPA has resulted in substantial consumer shopping or cost reduction, we would conclude that it has provided a positive atmosphere for a very difficult and challenging marketplace. RESPA has softened many of the structural disadvantages that accompany an industry so strongly characterized by reverse competition, and it has produced an overall positive effect upon the settlement process.

ALTERNATIVE 2: MAINTAIN THE STATUS QUO

An alternative that is no alternative at all, but rather represents a potential course of action for government policymakers, is to conclude that the current system of real estate settlement is performing adequately, and that change in this system is neither necessary nor desirable. We reject this alternative on the same basis that we rejected the repeal of RESPA. We believe that although RESPA has achieved some success in motivating home buyers to shop for settlement service providers, greater benefits can be achieved through improvements in the method of both implementation and enforcement. Although some cost savings might be attributable--at least indirectly--to the enactment of RESPA, changes in the current legislation can be designed to provide benefits under at least certain circumstances.

As a result, we believe that alternatives are available to more effectively structure some requirements of RESPA and to eliminate other requirements that may be unnecessarily restrictive. Each of these alternatives or recommended changes must be considered in light of its potential benefits and disadvantages. In the following section, a number of proposed improvements to the current Act are evaluated.

ALTERNATIVE 3: MODIFY RESPA TO IMPROVE ITS EFFECTIVENESS IN PROVIDING CONSUMER INFORMATION AND ENCOURAGING SHOPPING

This section discusses a number of possible improvements to the legislation as it was amended in 1975. As the Introduction (Chapter I) to this volume indicated, alternatives should be discussed in terms of advantages and disadvantages and the estimated dollar impact of proposed changes. Though that method of analysis is well suited for alternatives for reducing specific settlement-related costs, it is inappropriate for discussions of systemic efficiency and overall effectiveness in motivating consumer awareness and shopping. The value of changes that are recommended in this section is difficult to quantify, and that value is defined in terms of improvements in the consumer's well-being as a result of changes in the settlement process.

Recommendation 1: Distribute the SIB Earlier

Some lenders and many consumers among those we interviewed indicated the requirement to have lenders alone distribute the special information booklet (SIB) is relatively ineffective in providing the full benefits that might be derived from advance disclosure. In effect, a major objective of RESPA is compromised because responsibility for such disclosure is placed upon the mortgage lender. We recommend that the SIB be distributed so as to reach the home buyer earlier in his home search process; this suggests that the responsibility should be placed in the hands of the real estate agent.

Such a recommendation was endorsed by 70 percent of the home buyers who were interviewed, and it represents a number of advantages over other options to distribute the SIB to the home buyer prior to the loan application process. First, the real estate agent represents a more logical agent for distributing the SIB because he comes into contact with the home buyer long before the lender does. This procedure would allow the home buyer to become more knowledgeable in posing questions to the lender at the time of application, and it could allow the home buyer adequate advance notice that the terms offered by lenders may differ substantially and that shopping prior to the time of application may be very fruitful.

Second, the results of our two home buyer surveys indicated that only 57 percent of all buyers actually recalled receiving the SIB. Whether or not this figure is an accurate representation, it suggests that the current method for assuring delivery of the SIB is inadequate. Again, the real estate agent would be a more effective distributor of the booklet because the home buyer not only has earlier contact with the agent, but he is often either in frequent contact with him or is in contact with many agents. This higher frequency of contact represents a mechanism for more comprehensive distribution of the SIB than that presently provided by the mortgage lender.

The lender has been held responsible not only for all of the information disclosure requirements enacted by RESPA, but also for performing a number of other federal regulations. Transferring primary responsibility for distribution of the SIB to the real estate agent would more evenly distribute the compliance activities of RESPA, and it would shift the responsibility from a (relatively) small group of lenders to a much broader population of real estate agents.

The principal disadvantage of this recommendation, however, is that lenders do more than merely handout the SIB. They can knowledgeably discuss many of the topics presented in the SIB more comprehensively than can the real estate agent. Nevertheless, the most experienced real estate agents and nearly all brokers should be nearly as competent a source of relevant information to the home buyer as the lender. Any disadvantage in this regard can be corrected by better training of agents, which would contribute to providing better and more timely information to the home buyer.

A second disadvantage is that distribution of the SIB by the real estate agent alone would not cover all potential home buyers. Chapter IX of Volume II indicated that an increasing number of home owners sell their own homes, and there is no assurance that buyers in such cases would have first received a SIB from an agent. This problem is akin to that facing home buyers who either can make cash purchase or who are provided with first mortgage financing by the seller. Like these home buyers, potential buyers of homes sold by owners require an additional mechanism to assure timely receipt of the SIB. Hence it would be desirable to have lenders share rather than forfeit the SIB responsibility.

A final problem associated with this recommendation is the rather substantial opposition which the National Association of Realtors (NAR) can be expected to generate. Currently brokers are not regulated by the Federal Government, although there is federal jurisdiction for brokers violations of antitrust laws. On the other hand, the industry might now see this as an opportunity to reinforce their position that they provide all the comprehensive services to effect a sale. Nontraditional (flat fee and discount) brokers might perceive this responsibility as a vehicle for providing broader "consulting" services to their clients.

We believe that the net benefits posed by this recommendation would significantly offset problems in implementation. This could be one of the more beneficial modifications to current RESPA requirements. It would substantially increase both the coverage of SIB distribution and the lead time that is necessary to allow for effective shopping. However, questions of federal jurisdiction over the real estate brokerage industry persist. Consequently, voluntary participation by the brokerage industry is highly desirable.

Recommendation 2: Develop SIBs That Are Specific to a Locality

Although Chapter XIII of Volume II indicates that the overall adequacy of the SIB has been rated very highly by both lenders and home buyers, we believe that the current SIB should be modified. Reported deficiencies indicate that the booklet: (1) does not adequately prepare the home buyer to deal intelligently with the mortgage lender; (2) does not adequately address regional or local variations in lending practices and settlement service requirements; and (3) contains language and terminology that may be unfamiliar to many home buyers.

The mortgage financing process is a particularly complex one for most laymen, and it would be difficult to both reduce the complexity of the SIB and more adequately elaborate upon the terms and conditions of mortgage financing. We believe that there are dangers in attempting to further reduce the level of reading ability necessary to understand the SIB. It is presently written for the "average consumer" and addresses a relatively low common denominator of comprehensive ability. Although some attempts should be made to more lucidly interpret complex sections of the SIB, the booklet basically fulfills its purpose of conveying important, specialized (procedural, legal, and financial) and detailed information.

We agree with a small group of critics who contend that the SIB contains inadequate information concerning financing and the role of the lender. Specifically, the book should put more emphasis on the fact that borrowers are not required to accept providers recommended or even "required" by the lender. With the exception of a lender's frequent requirement for his own attorney, selection of a provider is often a negotiable process. Similarly, the home buyer would be better served by at least a brief discussion of such topics as: (1) prepayment penalties; (2) refinancing options and costs; (3) terms of assumability by subsequent home buyers; (4) variable rate and roll-over mortgage alternatives; and (5) the relative advantages and disadvantages of conventional financing vis-a-vis FHA or VA.

An additional recommendation addresses the need for SIBs that are sensitive to specific local market lending and settlement provisions. Such an effort would both shorten the existing SIB (by removing nonrelevant information) and allow specific local practices to be discussed at greater length. For example, the role of the escrow company in California and Washington could be better explained, along with a description of borrower rights with regard to the selection of providers (particularly providers of title assurance and conveyance services). In areas like St. Louis and Washington, D.C., greater attention can be paid to specific practices that differ across state boundaries. In all areas, a more comprehensive and exact discussion of local taxing and escrow requirements and of recordation and transfer costs can be provided.

This recommendation could be implemented with no change in current settlement procedures. Though substantial, additional costs are associated with both the preparation and the production of a regionally specialized SIB, we believe that those additional costs can be minimized by taking three specific steps. First, a basic SIB can be defined at the national level; it could represent something very close to an abridged version of the current SIB. Second, the basic SIB could be sent to a local group or committee composed of mortgage lenders, consumer advocates, and attorneys active in the settlement process. Many might contribute their time on a pro bono basis, and this group could assume responsibility for SIB adapting the basic SIB to local market conditions according to well defined HUD specifications. We would think that most states would require only a single SIB, although some SMSAs within a state might warrant specially prepared SIBs.

Finally, the locally prepared SIB could be returned (possibly to the HUD area or regional office) for conformity, final approval, and production. Increased costs would certainly result from this procedure. However, the SIB plays a particularly important role in the overall process of advance disclosure, and we believe that the additional expense allocated to this effort would produce valuable benefits. This recommendation is consistent with the spirit of Section 5(a) through (e) of the Act, and we feel it would strongly contribute to more relevant and more comprehensive disclosure.

Recommendation 3: Require Standardization of the Good Faith Estimate (GFE)

Section 5(c) of the Act requires that each lender shall provide loan applicants a good faith estimate by delivering or mailing it to a borrower within three days after application is received. Presently, the lender may provide the GFE on any form that conforms to certain requirements (3500.7 (d) (i)-(3) of the RESPA regulations). Of the lenders surveyed, 75 percent indicated that they used their own forms. The Act currently allows lenders to provide estimates in the form of either ranges or dollar amounts, with the stipulation that the estimate must bear a reasonable relationship to the charge that the borrower is likely to be required to pay, and that it be consistent with what closings on similar properties have required.

Our survey indicated that nearly seven out of eight lenders (87 percent) provided point estimates rather than range estimates; this was corroborated by a nearly identical proportion of consumers who indicated that they had received point estimates. We believe that a significant amount of potentially misleading information could be avoided if point estimates were required of the other 13 percent of the sampled lenders. Similarly, we recommend that all lenders be required to adopt Section L (see Exhibit II-1) of the HUD-1 form as the standard format for the GFE.

One advantage of this recommendation is that it would promote greater familiarity in interpreting the GFE. For home buyers who are familiar with the HUD-1 form, and particularly those who move and are required to go to settlement in a part of the country where settlement practices are different, the use of the HUD-1 as the form of the GFE will provide some continuity.

Secondly, the use of the HUD-1 as the form of the GFE facilitates comparison at closing to the actual HUD-1 forms. This allows for an actual item-by-item check of estimate vis-a-vis cost for each closing-related service or expense. Finally, the use of the basic Section L of the HUD-1 form would preclude the use of ranges in reporting estimates, and would, we think, encourage both more accurate and possibly more competitive pricing of estimates of total costs required in going to closing with a particular lender.

Twenty-one percent of the lenders reported that their estimates tend to be higher than actual closing charges. This may be accounted for by two distinct practices. First, many lenders will estimate that a full 30 days of prepaid charges for interest and taxes are required at settlement. However, these required prepaid items are reduced if the home buyer goes to settlement later in the month. Therefore, there is a natural tendency for many lenders to overestimate closing requirements. Second, and more importantly, the ranges that some lenders provide may be significantly broad ones. As an example, attorney charges may be estimated at between $150 and $300. This tends to create an expectation by the consumer of charges of about $225 (the mid-range) when, in fact, adequate legal services are usually available at the lower end of that range.

EXHIBIT II-1

UNIFORM SETTLEMENT STATEMENT
SECTION L (page 2 of HUD-1 Form)

L. SETTLEMENT CHARGES		
700. TOTAL SALES/BROKER'S COMMISSION based on price $ @ % =	PAID FROM BORROWER'S FUNDS AT SETTLEMENT	PAID FROM SELLER'S FUNDS AT SETTLEMENT
Division of Commission (line 700) as follows:		
701. $ to		
702. $ to		
703. Commission paid at Settlement		
704.		
800. ITEMS PAYABLE IN CONNECTION WITH LOAN		
801. Loan Origination Fee %		
802. Loan Discount %		
803. Appraisal Fee to		
804. Credit Report to		
805. Lender's Inspection Fee		
806. Mortgage Insurance Application Fee to		
807. Assumption Fee		
808.		
809.		
810.		
811.		
900. ITEMS REQUIRED BY LENDER TO BE PAID IN ADVANCE		
901. Interest from to @ $ /day		
902. Mortgage Insurance Premium for months to		
903. Hazard Insurance Premium for years to		
904. years to		
905.		
1000. RESERVES DEPOSITED WITH LENDER		
1001. Hazard insurance months @ $ per month		
1002. Mortgage insurance months @ $ per month		
1003. City property taxes months @ $ per month		
1004. County property taxes months @ $ per month		
1005. Annual assessments months @ $ per month		
1006. months @ $ per month		
1007. months @ $ per month		
1008. months @ $ per month		
1100. TITLE CHARGES		
1101. Settlement or closing fee to		
1102. Abstract or title search to		
1103. Title examination to		
1104. Title insurance binder to		
1105. Document preparation to		
1106. Notary fees to		
1107. Attorney's fees to		
(includes above items numbers;)		
1108. Title insurance to		
(includes above items numbers:)		
1109. Lender's coverage $		
1110. Owner's coverage $		
1111.		
1112.		
1113.		
1200. GOVERNMENT RECORDING AND TRANSFER CHARGES		
1201. Recording fees: Deed $; Mortgage $; Releases $		
1202. City/county tax/stamps: Deed $; Mortgage $		
1203. State tax/stamps: Deed $; Mortgage $		
1204.		
1205.		
1300. ADDITIONAL SETTLEMENT CHARGES		
1301. Survey to		
1302. Pest inspection to		
1303.		
1304.		
1305.		
1400. TOTAL SETTLEMENT CHARGES (enter on lines 103, Section J and 502, Section K)		

HUD-1 Rev. 5/76

FEDERAL REGISTER, VOL. 41, NO. 113—THURSDAY, JUNE 10, 1976

We believe that the use of ranges--although reasonable--is potentially misleading, discourages shopping, and may foster abuses in the form of higher than necessary costs. Requiring the HUD-1 form as the format for the GFE would circumvent these problems and would provide other benefits in terms of continuity and familiarity. This recommendation would be implemented with somewhat greater difficulty than the previous one. Section 3500.7 of the RESPA regulations would have to be amended both to mandate the form and to require point estimates, and three-quarters of the lenders in our sample group would be required to change their reporting practices.

We do not believe, however, that there would be significant industry resistance to this proposed change. Nearly all lenders are very familiar now with the HUD-1 form, and this would facilitate their ability in completing the GFEs.

Recommendation 4: Require Earlier Delivery of the Good Faith Estimate

The sooner the GFE can be placed into the hands of the loan applicant, the greater the opportunity for shopping. An inherent weakness in the current system is that it does not get the GFE to the home buyer until after the application process and, more importantly, often until after he has paid for such items as credit report, appraisal, and possibly an application fee. As a result, the information presented in the GFE may be provided too late if a loan applicant might forfeit front-end charges paid at application.

Remedies to this situation require a substantial change in the application process currently used by most mortgage lenders. Nevertheless, we believe that the usefulness of the GFE can only be maximized when the estimate is provided to the home buyer: (1) at the time of application; and (2) prior to the prepayment for charges that are typically required at application.

Although many lending institutions may argue that they possess inadequate information to prepare a GFE, at the time of application, these problems can be circumvented by using range estimates for such items as purchase price, down payment, settlement date, type of property, mortgage rate, and points. Nearly all title, legal, mortgage insurance, recordation, escrow and lending-related costs can be derived from these estimates, and all lenders who are active loan originators should be able to provide good estimates of these costs at the time of application. As a result, we recommend that the GFE be presented to a home buyer at the time of application, and that the GFE be based upon certain estimates concerning financing requirements with which the loan applicant has concurred.

It is also necessary, however, that the home buyer be given adequate time to shop for comparative closing costs prior to prepaying application charges. Implementing this recommendation poses a more difficult problem because it requires that initiation of the loan evaluation process be delayed until after the applicant has been given an opportunity to shop and after he has made a decision to pay for credit review, appraisal, and possibly other nonrefundable fees. It also requires that lenders spend time taking loan applications and providing GFEs for applicants who may be only "shopping" or who may be unlikely to actually go to settlement. As a result, this recommendation requires lenders to invest a substantial amount of time in loan applicants who may never become actual customers.

We acknowledge that this recommendation may require a delay in the loan evaluation process and represent an increase of cost to the lender that must eventually be assumed by some party. Such a situation would be a strong inducement for the lenders to provide a GFE that would attract shoppers to become actual loan applicants. Possibly the costs of fulfilling this requirement could be, in part, offset by allowing the lender the option of charging a small "consultation" fee (possibly $25, and applicable towards the credit and appraisal fees), which would include the preparation and distribution of the GFE. In either case, the applicant would be allowed timely receipt of the GFE and other advice (at only a small cost under some circumstances) and he would be placed in a substantially better position if he would choose to comparison shop.

This recommendation would require a rather significant change to current RESPA regulations, and it is probable that lenders would be particularly resistant to what they may view as a new and imposing restriction. However, despite marginal costs and the consequent delay in the loan evaluation and application process, we believe that this recommendation would contribute greatly to allowing a potential borrower full benefit from the GFE.

Recommendation 5: Develop Mechanism to Ensure More Uniform Completion of the HUD-1 Form

Our interviews indicated that providers were more critical of the Uniform Settlement Statement (HUD-1 form) than were buyers or sellers. These results are not surprising, in that consumers merely require a format that is basically understandable, while providers and particularly those parties responsible for preparation of the HUD-1 require a form that is comprehensive, unambiguous, and able to accommodate specific and sometimes atypical circumstances. During our process of collecting and analyzing the HUD-1's, we found a relative lack of conformity in reporting certain costs or groups of costs. We believe this practice should be corrected, and feel that it can be most effectively accomplished by the distribution of a booklet to lenders describing acceptable and nonacceptable ways of reporting settlement costs.

The advantages of this recommendation include benefits to nearly all closing-related parties. First, a more accurate HUD-1 form will improve its overall usefulness. Half of the responding title insurers and over 40 percent of the responding lenders indicated that the form was only slightly or not at all useful. A booklet describing standard reporting practices would help eliminate definitional and interpretive problems regarding the location of specific types of charges, making it a more useful document for both lenders and other settlement agents responsible for its preparation.

Second, a booklet that more comprehensively describes the correct, standard preparation of the HUD-1 would provide a fine training device for new loan officers, and it could better prepare other lenders (particularly those in small, non-urban commercial banks) to use the HUD-1 form and become more active residential mortgage lenders. Our sample did not allow for direct interviews with mortgage lenders outside of the major suburban areas of eight SMSAs. However, telephone conversations early in our study indicated that some less active mortgage lenders are substantially ill-prepared to complete the HUD-1, and for some, it may actually represent a deterrent to mortgage lending.

A more uniform HUD-1 would also benefit home buyers and sellers who are experienced in the settlement process. More uniform completion would also substantially benefit government agencies and analysts by improving both the ease of conducting subsequent studies and the confidence in the results of such efforts.

The disadvantages of this recommendation include only the time and resources required to produce and distribute such a booklet. No new regulations would be required, with the exception that reporting requirements might become more precise and current discretion that is currently allowed some lenders and settlement agents would be revoked. Just as we have recommended that local parties play a role in making the SIBs more relevant and locally specific, such groups could also be invited to participate in the design of these booklets for lenders. In that way, specific settlement requirements could be addressed, subject to final HUD approval.

Recommendation 6: Improve the HUD-1 Form

In the course of our analysis of the HUD-1 forms, we were able to identify a number of additions or modifications in format which we feel contribute to better disclosure (at settlement and at time of delivery of the GFE, should Recommendation 3 be implemented) and to better subsequent policy evaluation. We suggest that the following information be included:

- specific lending terms (include mortgage rate, term, amortization schedule, whether or not a variable rate, balloon type or other alternative mortgage instrument, type of FHA 245 plan, etc.); and

- all specific amounts paid outside of closing (POC).

We also suggest that changes in the format be made to allow better interpretation of the meaning of certain line items or charges. This is true particularly of lending-related fees (origination fees, administrative or application fees, commitment fees) and certain legal and title related fees.

For example, providers are now permitted to report all items under the title charges (1100 series) in one total amount. When attorneys conduct settlement and complete the HUD-1 form, frequently the title search, document preparation, and settlement fee is added together and reported as the attorney's fee. At other times, no attorney's fee is reported but charges for settlement may be very high. Further, consumers are not really aware of how much they are paying for attorney involvement in many cases since the attorney's fee on the HUD-1 may be very low.

The advantages of these changes in terms of better disclosure and a more complete summary of available information would have to be considered against the disadvantages associated with a new (or at least modified) form, and the temporary difficulty or confusion that it might generate. Some of these suggested improvements or additions could be implemented by relatively straightforward changes to Sections A through I of the form. Others, however, which would require a restructuring or redefinition of line items in Section L of the form, would be more difficult to implement. We recommend that such changes be contemplated only if a booklet describing uniform reporting practices (Recommendation 5) were distributed. This would serve as a comprehensive tool for describing changes, and would ease the difficulty in making comparisons from one form to another.

A second disadvantage in altering the current HUD-1 form is the problems that might later develop in attempting to summarize and compare data prior to and following any changes. This, we feel, is only a small obstacle, but it requires that adequate consideration be given to any changes to assure that the transition would be made easily and would easily accommodate the requirements of subsequent analysis.

In summary, we feel that this recommendation is useful but only of marginal significance. Although some criticism of the basic HUD-1 form is legitimate, it has fulfilled the expectations and needs of over 70 percent of the consumers to whom we spoke. Changes to this form, particularly to portions contained within Section L, should be undertaken only to the extent that they complement, and are made easier by, other changes that are initiated.

Summary of Recommendations to Improve Effectiveness

Each of these six recommendations is intended to improve the consumer's understanding through modifications in the current RESPA requirements. These represent some of a larger number of suggestions that have been developed during this study or have been provided by persons interviewed in the course of our data collection. Others have been dismissed because they appear internally inconsistent, because they would be unworkable due to positive requirements of the current settlement market structure, or because we felt that their perceived advantages do not outweigh the financial, social, and efficiency costs which they entail.

We believe that all six recommendations could be initiated as a package, and that maximum benefit would be provided through implementing all of these changes. However, each of these recommendations (with the exception of parts of Recommendation 6), could be applied individually or in nearly any combination, but we believe that the least disruption and confusion would result if all desired changes were introduced at one time.

A final word is necessary concerning the possible need for mechanisms to ensure compliance with the requirements of RESPA. We believe that the findings presented in Chapter XIII of Volume II are disappointing in that they indicate: (1) a substantial proportion (43 percent) of home buyers claim they do not receive the SIB; and (2) nearly 17 percent of home buyers do not receive the GFE. However, these responses contradict those of lenders, who report nearly full compliance with requirements of timely distribution of both the SIB and the GFE.

We do not feel that major efforts to ensure further compliance are necessary, and we strongly question the cost-effectiveness of such efforts. Instead, we believe that the particular implementation of a requirement to have the SIB delivered to the home buyer prior to the loan application process would correct the problem represented by so small (57 percent) a distribution ratio for the SIB. This remedy would also improve the level of borrower expectations, and it would likely encourage more consumers to request (or demand) GFEs from lenders who might otherwise not be inclined to deliver them.

Efforts to improve compliance with those sections of RESPA addressed in this chapter are not considered necessary. However, alternatives will be presented in the next chapter which may require that better controls be initiated to ensure compliance with other sections of the Act dealing with specific industries.

III. ALTERNATIVES DESIGNED TO REDUCE THE COMPONENTS COST OF SETTLEMENT

The prior chapter focused upon alternatives that are designed to more effectively promote disclosure and encourage consumer shopping for the total package of settlement-related services. However, we feel that this aggregate approach to evaluating settlement costs can be misleading, and it can shift consumer concern away from individual costs that may be somewhat easier to reduce by making the provider markets more competitive. Many of the reccommendations that were posed in the preceding chapter might encourage consumer shopping, but they would not, in themselves, be adequate to bring about significant reductions in costs. The alternatives that are considered must make specific settlement service markets more sensitive to consumer interests, and more apt to respond in ways favorable to price competition.

Three basic tools are available in implementing alternatives designed to reduce the cost of settlement services. One method employs direct regulation in attempts to fix or limit prices; a second uses direct market intervention to support greater industry competition. A third method is less explit and certain, but it also allows significantly greater ease of implementation; it encourages greater price competition through actions designed to supplement available consumer information and to transfer the responsibility for the selection of service providers more towards the consumer. In effect, this third group of actions involves steps to reduce the difficulties and abuses currently structured into the system characterized by reverse competition.

Throughout this discussion of alternatives, we strongly favor the use of market forces rather than industry regulation as the basic tool of corrective action. In many situations, efforts to increase the price competitiveness of a marketplace may be successful, but in others the current regulatory environment may be inadequate to allow the correction of abuses. In these cases, regulatory intervention should be considered.

This chapter presents a number of alternatives which have the impact of increasing disclosure, encouraging shopping, and directly reducing costs. In some cases, these alternatives are mutually exclusive, but more often, a combination of alternative actions can be taken to positively impact the residential settlement process. Although some or all may be deemed highly desirable, they each represent costs in terms of time, effort, and the likelihood of market disruption that could be counterproductive. As a result, these alternatives must be prioritized so that a rationing of modifications and corrective efforts can lead to the broadest reduction in settlement costs.

A final point needs to be made concerning our interpretation of the definition of settlement costs. We feel that the primary motivation underlying the enactment of RESPA has been to achieve a reduction in the cost of specific settlement services. We have interpreted this as a reduction in the "present value" of the costs of those services. Some actions by the mortgage lending and mortgage insurance industries have allowed current obligations for settlement costs to be exchanged for deferred liabilities. We feel that these actions represent productive alternatives that allow consumers to better match home purchase requirements with their capital and earnings capabilities. However, we do not view these as reductions in settlement costs. Although we favor alternatives that will allow home buyers to defer some of the costs of home purchasing, we will consider only those actions that effectively reduce the cost of settlement.

This chapter addresses alternatives that are specific to particular industries and that are designed to reduce the cost of specific providers. Alternatives to the current structure and operations of the real estate brokerage industry are considered first. These are followed by a presentation of alternatives to the mortage financing industry, to the mortgage insurance industry, and to the current process for providing legal and title-related services at closing.

ALTERNATIVES TO REDUCE THE COST OF BROKERAGE SERVICES

Our analysis of market performance for the real estate brokerage industry resulted in two primary conclusions. First, active price competition tends not to exist among brokers. There is substantial evidence of relatively uniform prices across localities, over time and across significantly different market conditions. As shown in Exhibit IX-1 in Volume II, in four of the eight cities for which we analyzed HUD-1 survey data, 80 percent or more of the commission rates charged were exactly 6 percent of the selling price; in each of the remaining four sites, more than half of the commission rates were either exactly 6 percent or exactly 7 percent. Our analysis of data from another source for 1975, 1978, and 1979 also revealed a strong pattern of commission rate uniformity, which stems in part from a recently broken tradition of broker trade associations fixing or recommending an industry-wide commission rate, is not consistent with the existence of active price competition. The available data also suggest that commission rates are higher than would prevail in most cases if active price competition prevailed in the industry.

The second major finding is that most consumers are satisfied with the services provided by brokers. Among the 81 percent of home sellers in our survey who used a broker, 63 percent were very satisfied and 19 percent were somewhat satisfied, while only 18 percent were either somewhat or very disappointed with their broker's performance.

Another significant finding is the importance of the broker as a referral source for other settlement services. For 70 percent of the buyers surveyed, the broker recommended the use of at least one other settlement provider, most often lenders, title insurance companies, escrow companies, and mortgage insurers, in that order.

Alternatives are advanced here which relate to prices charged for brokerage services and the quality of those services. Alternatives which respond to problems related to the referral system, or reverse competition, are addressed in other portions of this chapter. In considering alternatives which seek to lower prices, it is instructive to put brokerage costs in perspective. Brokerage fees represent the largest cost component among settlement costs; in fact, they exceed all other settlement costs combined. The HUD-1 data analyzed indicate that broker's commissions represented 5.8 percent of an average contract sales price of $54,864, or $3,182.[1] This compares with the total of all other settlement costs of $2,030. (See Exhibit XV-2 in Volume II.) Thus, reducing brokerage costs, even by a relatively small percentage, would bring about a significant reduction in settlement costs, probably dwarfing potentially achievable cost reductions in any other settlement service.

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[1] As noted, brokers were used by approximately 80 percent of all sellers, so that the average cost for all sellers approximated .80 x $3,182 or $2,545.

The alternatives presented here should be considered within the framework of a changing legal environment for brokers. Increasingly, the pricing activity of brokers and their local boards has come under the attention of the courts. Numerous class action suits have been filed alleging anticompetitive activity by brokers and their local boards. In perhaps the most important decision, Mclain V. Real Estate Board of New Orleans, the U.S. Supreme Court (100 S. Ct. 502 (1980)) decided that federal courts do have jurisdiction in cases involving alleged price fixing activities by real estate brokers and their local boards.

These cases and the publicity they have generated within the industry and among the general public, may have changed attitudes regarding the fixed nature of commission rates. We sense an increased incidence of sellers seeking to negotiate lower commission rates and a decreased incidence of brokers responding that reducing commission rates is a violation of professional ethics or cannot be done for other reasons. This change in attitudes may make the industry more receptive to efforts to increase the extent of price competition for brokerage services.

Finally, implementation of the alternatives described here involves important legal issues, particularly that of jurisdiction between Federal and State government agencies and regulators. These alternatives have not been subjected to an adequate legal or constitutional review.

Alternative 1: Encourage Publicizing the Non-Fixed-Price Nature of Commission Rates.

Though real estate brokers and agents typically act in a highly competitive manner, they generally do not compete by lowering the commission rate. However, commission rates are negotiable. Neither local Boards of Realtors nor multiple listing services can legally enforce adherence to the prevailing commission rate. Our survey indicates that 30 percent of sellers sought to negotiate terms of the listing agreement (commission rate and/or other terms of the agreement), and 10 percent succeeded in negotiating a reduced commission rate. Nevertheless, a large proportion of sellers are not aware that commission rates are negotiable.[1] This alternative would seek to increase public awareness that terms of agreements with brokers including commission rates, are negotiable. This can be through press releases, speeches and, other means of educating the consumer by federal agency officials, state and local consumer agencies, and others. In addition, the Special Information Booklet (SIB) could be revised to reflect the negotiability of terms of the listing agreement. Brokers could also be required to distribute it to sellers prior to the signing of listing agreements, where federal assistance of some kind is involved in the transaction.

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[1] In our survey, 35 percent of sellers indicated they were not aware that terms of the listing agreement were negotiable.

Advantages

Because of the history of brokers' establishing a single fixed commission rate through their trade associations and the apparent success of that effort, many sellers may not be aware that commission rates are legally as negotiable as other prices. Efforts to educate the consumer regarding the negotiability of the commission rate and other terms of the listing agreement could increase the extent of consumer shopping for brokers. If consumers shopped more, and asked questions about the commission rate, this would likely precipitate inceased price competition among brokers and perhaps some flexibility in the mix of services offered to the home seller. To the extent that this occurred, commission rates would tend to decline. Another advantage of this alternative is ease of implementation.[1] Additional regulations would not be required nor would the structure of the industry or of services provided to the consumer be significantly altered.

Disadvantages

It is uncertain whether a publicity and public education campaign would be successful. Consumers who do not expect to sell their homes in the near future may not be attentive to the type of public education effort outlined. When they are ready to sell their homes, the information may not be conveniently available during the often short period before a broker is contacted and a listing agreement is signed. It is also not reasonable to expect brokers to play an active role in educating their customers as to negotiating options for the listing agreement. If the broker does not distribute the SIB, the seller is not likely to receive and examine it before a listing agreement is signed. Requiring the broker to distribute the SIB before the listing agreement is signed would require increased regulations and monitoring and enforcement effort in order to ensure compliance.

Evaluation

We believe that an effort by appropriate federal, state, and local agencies to publicize the negotiability of commission rates and other terms of the listing agreement is highly desirable. It is a relatively low-risk option which, if performed competently and agressively, can be expected to substantially increase the degree of price competition among brokers. Ultimately it should result in lower commission rates for many.

Because of the cost and the need for increased regulation to require brokers to distribute the SIB before the listing agreement is signed, we are neutral on this feature of the alternative if its primary purpose is to induce greater price competition for brokerage services. However, we do believe it would increase the extent of price negotiation by home sellers.

Requiring the broker to distribute the SIB should increase the extent of consumer shopping and price competition for other settlement services as well. That is why it was recommended in the previous chapter.

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[1] Other than the requirement for the broker to distribute the SIB.

Alternative 2: Ensure that the Multiple Listing Service Does Not Operate to Restrict Price Competition.

In most large cities, the Multiple Listing Service (MLS) is a primary means of providing information to member brokers regarding the availability, prices, and characteristics of houses. In many cases it is operated by a local Board of Realtors. The MLS, depending on how it is operated, may also serve to discourage brokers from lowering commission rates. It may do so by:

- denying membership to discount brokers;
- requiring that the sales commission rate be the prevailing one in the area; or
- explicitly listing the commission rate and rate split.

At this time it is illegal to deny membership in the MLS to discount brokers or to require a minimum or stipulated commission rate as a condition for listing with the MLS, but these practices may occur in some areas. Our interviews with alternative brokers suggest that these practices are not uncommon. Where they do occur, they can discourage price competition among brokers. Explicitly listing the commission rate and commission split may discourage some brokers from cooperating on sale but more importantly, may facilitate or even invite peer pressure on the discount broker to increase his commission rate. This could take the form of a boycott of the discount firm by the standard commission brokers.

An alternative which has been proposed is to encourage state and federal regulatory authorities to enforce more effectively existing antitrust laws regarding the activities of local MLSs and to prohibit the MLS from indicating as part of the listing the commission rate and commission rate split between selling and listing brokers.

Advantages

This alternative would help prevent the MLS from serving as a tool to inhibit the activities of discount brokers and to discourage price competition among conventional brokers. It would prevent local broker groups from using the MLS to shore up the prevailing commission rate. It would thus facilitate a lowering of commission rates where they are justified by market conditions. It would also encourage a greater range of services offered by both traditional and alternative brokers, at an accompanying range of prices.

Disadvantages

The MLS serves as a valuable tool in providing relevant market information quickly and efficiently to member brokers. Excessive interference by federal and state authorities might reduce the efficiency of the MLS. Yet the need for the enforcement of our antitrust laws cannot be disputed.

The prohibition against providing information in the MLS listing on the commission rate and listing-selling agent split may be inequitable and counter-productive. It may be unreasonable to deny an agent convenient access to information regarding how much he or she will earn for selling the house. This would deny the agent information needed on how to allocate his or her time and effort most efficiently. Agents want this information and will get it through other means, though perhaps less efficiently. Not providing commission rate information on the MLS listing is not likely to prevent other agents from gaining access to it, nor if they wish, from seeking to prevent price cutting through peer pressure, boycotts, or other means.

Evaluation

Enforcement of the antitrust laws would help prevent exclusion and discrimination against brokers who are willing to lower their commission rates.

We do not think it reasonable to prohibit commission rates and rate splits from inclusion in the MLS listing.

Alternative 3: Encourage the Use of Brokers Who Represent the Buyer.

Currently, the listing broker represents and is paid by the seller (and has a fiduciary responsibility to him); while the broker who brings in a potential buyer is legally a subagent of the selling broker, rather than a representative of the buyer. The selling broker is also paid by the seller, although generally through the listing broker. This structure may leave the buyer inadequately represented and in a poor position to negotiate with the seller and the listing agent.

This alternative is proposed to help implement a system where the buyer may choose a broker to represent him. The buyer's broker may be paid contingent on the purchase of a house or be paid on the basis of time and effort expended, by a flat fee, through a fee schedule for agreed upon services, or by the hour. The buyer's broker would be paid and be legally bound to represent the buyer rather than the seller or the listing agent. A listing broker would agree to deduct one half of the commission, or whatever is the portion that typically goes to the selling broker in that locality.

Advantages

A buyer broker can better represent the interests of the buyer. Currently, there are two primary ways a buyer may purchase a house that is listed by a traditional broker:

- deal directly with the listing broker; or

- use a broker to assist him in finding a house and in negotiating terms of sale.

Under the first option, the listing broker clearly does not represent the buyer's interest; he is paid by the seller if the house is sold. In showing the house and in negotiating the terms of sale, his allegiance is likely first to the sale -- if there is no sale he does not get paid -- and to the seller. That is, he may seek the highest price for the house consistent with making a sale. He may advise the seller not to accept what he considers a low offer, knowing that he will earn a commission if the house is sold to someone else. If the potential buyer uses a broker other than the listing broker, that broker earns a commission only if the potential buyer purchases the house. Moreover, because there is no contract with the potential buyer, the buyer may be working with one or more other brokers. The broker who is assisting the buyer is invested in selling the houses he shows the buyer. In negotiating terms of sale, he may be reluctant to seek a lower price from the seller if it jeopardizes the prospects for a sale.

If the buyer were represented by a broker, who was paid irrespective of a sale, the broker would be in a better position to assist the buyer in selecting a suitable house and in negotiating terms of sale. Even if the buyer's broker were paid contingent upon the purchase of a house, if he had an exclusive contract with the buyer covering some fixed period he would be less inclined to seek the completed purchase of a particular house than if there were no contract.

Disadvantages

This alternative would significantly alter the current arrangement among brokers. Our survey indicates a high degree of consumer satisfaction with brokers, which might be jeopardized by intervening in the way services are provided. There may be many abuses under this proposed plan that are currently unforeseen.

Evaluation

We recommend further development of this alternative and implementation on a pilot project basis. If legal or regulatory barriers to the buyer broker idea exist, they would have to be removed. Implementation would not seem to require regulatory activities. Rather, brokers in a particular locality may consider adjusting their standard contracts to facilitate its implementation on a trial basis. It would seem to have substantial potential for improving the quality and integrity of services offered to the home buyer.

Conclusion

Independent of the implementation of any of the alternatives advanced, the changing legal atmosphere relating to broker commission rates and what appears to be a growing consumer awareness of the non fixed-price nature of those rates, suggests increasing price competition in the market for brokerage services. But that growth may be slow. We believe that each of the alternatives described here will contribute to a more efficient market and more cost-effective services for the consumer. However, Alternative 1, which would publicize the non-fixed price nature of broker commission rates, would seem likely to result in the greatest increase in price competitiveness of the market and the largest reduction in commission rates, while including the least risk of adverse consequences. We urge that it be seriously considered for implementation.

ALTERNATIVES TO REDUCE THE COST OF MORTGAGE ORIGINATION AND FINANCING SERVICES

The HUD-1 survey results that are presented in Chapter XV of Volume II indicate that items paid in connection with the loan (the 800 series in Section L of the HUD-1 form) represent the largest, non-brokerage related component of settlement costs. These items represent charges for appraisal and credit reports, special inspections by lenders, processing fees (which may be called loan fees, application, origination, commitment or assumption fees), and loan discount points. Usually, they are all paid by the buyer, although there are exceptions. Limits are routinely placed upon the number of points that may be charged buyers; as a result, sellers are often required to pay discount points in order for the buyer to secure financing. In some cases where FHA or VA financing is arranged, these points can represent a significant expense. Sellers may also pay miscellaneous other fees in place of the buyer if such items have been defined as part of their contractual arrangement.

Chapter X of Volume II, which describes the performance of the mortgage lending market, indicated that nearly all of these fees are either tied directly to actual expenses associated with the origination process, or represent charges that are inseparably a part of the yield requirements of the lender. Alternatives designed to control or limit these costs through direct price regulation would likely disrupt the market and existing financing mechanisms. Such alternatives would discourage the continuous availability of residential mortgage money, would allow lenders the eventual option of passing costs through to borrowers by other means (mortgage rates, prepayment penalties or mortgage rate adjustments), and would be difficult both to implement and enforce. Existing mechanisms allowing the flow of money from the broader credit markets into the mortgage market work relative efficiently, and we believe that attempts to reduce loan-related settlement costs through regulatory controls or limitations would be more detrimental than positive.

This does not suggest, however, that loan-related costs cannot be reduced. Instead, it implies that efforts to increase industry competition would be both more desirable and more effective than would price regulation. There are, however, some examples of problematic practices that might be corrected with minimum market disruption through some forms of regulation. These, as well as alternatives designed to better inform consumers about specific loan-related matters, are presented in the following discussion.

Alternative 1: Encourage Home Buyers to Shop for a Loan Commitment Prior to Shopping for a Home

In nearly all situations, a home buyer will seek out a mortgage lender only after he has made a decision to purchase a home and has signed a sales contract. There is, however, no necessary reason for this order to be followed, and it is possible that both greater efficiencies and greater savings could be realized if these two steps were reversed. This alternative suggests that home buyers be motivated to apply for a loan first or to do so concurrently with their search for a home.

Advantages

Problems are encountered by buyers, sellers, and even lenders because of this traditional ordering of activities by the home buyer. From the perspective of all three parties, it would be much more efficient for the buyer, and particularly one who is inexperienced, to first become aware of: (1) the size of the loan for which he can qualify, and (2) the amount of cash that the settlement process will require. By having first applied for a loan, and been approved, the buyer can more accurately recognize his purchasing capacity and can act more decisively in making a home purchase decision.

The lender would be in no position to give final loan approval because he must first see a contract and a property appraisal, but he would be able to provide conditional approval based upon prior underwriting of the applicant. Having received prior or conditional loan approval, a home buyer might be able to negotiate a more attractive purchase price because he can make an offer that is not contingent upon his ability to secure financing. Prior loan approval would also shorten the time between the actual signing of a contract and the loan commitment, and this would also provide the buyer an advantage in being able to offer the seller very quick settlement.

This alternative would provide greater assurance to a seller when accepting a contract, which might then become contingent only upon the property supporting the necessary appraisal value. It would also prevent problems that have occasionally occurred when buyers make an earnest money deposit on a home and sign a contract that may contain no language making the agreement contingent upon the ability of the borrower to qualify for financing. Sometimes such deposits have been forfeited after the proposed buyer has been unable to find a lender willing to make the necessary loan.

Finally, this alternative would encourage home buyers to become much more familiar with the terms of mortgage lending and with settlement costs well in advance of their actual need for these services. It would eliminate the problems encountered by some buyers who have (or take) little time to shop for lending alternatives, and it would represent a very effective mechanism of advance disclosure.

Disadvantages

Mortgage lenders may be opposed to this alternative because it would cause them to take applications at some cost and underwrite many potential home buyers who might not, in fact, actually become customers. Despite the advantages of such a plan, buyers might also be reluctant to deal with lenders before they have made a specific decision to purchase. On the other hand, real estate agents would probably be supportive of this alternative because it would eliminate one of the more frequent reasons that contracts fall through, and it would allow them to work more efficiently and confidently with potential buyers.

The difficulty posed by this alternative is that it represents an action that cannot be legislated or regulated, but that can only be encouraged. Home buyers cannot be required to first qualify for mortgage financing before they begin shopping for a home, and as a result, the alternative will be successful only to the extent that consumers can be motivated to act in this way.

Evaluation

This alternative would work very well in combination with Recommendation 4 in the prior chapter, which suggested that lenders be required to deliver a GFE to a borrower at the time of loan application and prior to the payment of any substantial fees or charges. Even taken alone, however, this alternative would make a significant contribution to advanced disclosure and greater market awareness, and we feel that relatively inexpensive efforts could be made to encourage both home buyers and lenders to adopt policies that would provide advance or contingent loan commitments.

Alternative 2: Require that Lenders Provide Up to A 30-Day Commitment to a Stated Mortgage Rate

The tremendous volatility that the mortgage markets have demonstrated during 1979 and into 1980 has discouraged lenders from issuing either: (1) long-term commitments to fund a loan, or (2) any commitment to fund at a stated mortgage rate. Chapter III of Volume II described the mortgage lending process and indicated that a lender is incurring a market risk any time that he issues a commitment; under conditions of increasing interest rates and a scarcity of mortgage money, that risk can be particularly costly. As a result, many borrowers have gone to closing without knowing specifically what mortgage rate they will be required to pay. In some cases they have found that substantially higher points or a higher interest rate is required, and they are provided no alternative but to pay the higher required rate and/or charges. In other instances, the potential home buyer may no longer be able to qualify for the loan because his earnings may not support the higher required monthly payments.

To some extent, this alternative acknowledges the occasional need for a compromise between the interests of the lender and those of the loan applicant. Particularly during periods characterized by volatile credit market conditions, the borrower and lender are in adversary positions with regard to assuming interest rate risk. The lender would wish to shift all risks due to rising market interest rates to the borrower; the loan applicant, on the other hand, would want to know with certainty the ceiling rate that he will be required to pay. This represents a sort of "zero sum game". Interest rate risk must be assumed by one party, and the terms of the commitment will define by whom.

We strongly believe that a policy requiring lenders to assume all or nearly all interest rate risk results in a risk premium being assessed all borrowers and implicitly may increase financing costs for all mortgagors. As a result, we would argue that a commitment term of 30 days is adequate to provide borrowers with the benefits of certainty and advance disclosure of settlement terms, while not requiring that a substantial portion of interest sale risk (that, for instance, would result from a commitment term of 60 days or more) be shifted from borrower to lender. Although it can be argued that a long commitment term of 60 days or more is desirable from the consumer perspective, that argument does not acknowledge the economic reality that the inherent "costs" of this added risk will be passed back to the consumer.

By declining to issue a long-term commitment (possibly 60 to 120 days) or by declining to commit to a stated interest rate, lenders are effectively passing market interest rate risk on to the borrower. In selected situations, however, borrowers may be particularly unable to absorb this risk. To preclude such situations, this alternative proposes that lenders be required to provide mortgagors with at least a 30-day commitment at a stated mortgage rate.

Advantages

This alternative benefits only those mortgagors who presently would receive no commitment from their lender or those who would receive a commitment for a period of less than 30 days. For these mortgagors, a 30 day commitment may be inadequate in providing full protection, but it would allow benefits of greater certainty and advance disclosure. Such advantages can be very important. First, the alternative would allow borrowers specific notice at least 30 days prior to settlement concerning their required mortgage rate and required points. This does not give borrowers a generous amount of time to seek alternative financing arrangements, but it does eliminate the surprise factor that has accompanied some settlements, and it does give borrowers an effective "cooling off" period during which to reconsider the desirability of actually going through with the settlement.

Second, this alternative requires lenders to think in terms of providing at least a 30-day commitment to a specific interest rate, and during periods of stable or declining mortgage rates, they may be more inclined to extend the term of that commitment to allow the borrower even greater flexibility and advance notice. In fact, many lenders commonly follow this practice now, but during periods of tightening credit market conditions, they may stop doing so. Ideally, this alternative would encourage some lenders to commit to a stated interest rate immediately upon loan approval, or even at time of application. However, when application precedes settlement by a relatively long period, it is relatively unlikely that such a commitment would occur.

Disadvantages

By requiring at least a 30-day commitment to a specific interest rate, this alternative denies mortgage lenders some degree of flexibility or discretion, and it is likely that the industry would strongly resist such an effort. The alternative is based on the argument that if market interest rate risk is to be absorbed, the lender is better suited (i.e., he is more knowledgeable and he has a broader base over which to distribute that risk) to bear it than is the borrower. However, interest rate risk is only one of a number of business-related risks that the lender must assume, and all of these risks (and the expected losses that are associated with them) are eventually translated into higher yield requirements. As a result, it is possible that the higher risk associated with this alternative (to the extent it is perceived), would eventually be passed on to some or all borrowers in another form.

A lender may respond to this requirement by one of three alternatives. First, he may simply attempt to offset his additional risk by assessing other fees or charges to all borrowers. Therefore, even borrowers who take out mortgages at low market interest rates may see their settlement costs increase. Second, lenders may simply "close the window" and not make mortgage loans during periods of rising interest rates when they consider it too risky to issue a commitment to fund at a stated mortgage rate. In many cases, this is the course some lenders followed during early 1980.

Finally, a lender could fulfill the letter of this requirement by simply agreeing to commit a rate that is equal to or lower than X percent, and that stated interest rate could be significantly higher than rates might be anticipated to go even under unusually tight credit market conditions. This suggests that the alternative might provide no benefits under specifically those conditions that is was designed to improve.

Evaluation

This alternative would be useful in eliminating both the uncertainty and the anxiety that can accompany settlements where the borrower is unsure what interest rate he will be required to pay. It would require the lenders respond even more cautiously to tightening market conditions. The intent of the alternative is positive and certainly warranted in select circumstances, but unless it were made much more restrictive, it would allow lenders to respond in ways that would be counterproductive or ineffective. In view of these limitations, the alternative might still be deemed desirable, but it would appear that its limited advantages might not outweigh the burdens and the probability of failure that might accompany implementation.

Alternative 3: Encourage Lenders to Provide Borrowers the Option of Increasing the Interest Rate and Reducing Points

The substantial cost represented by loan-related expenses is, in many cases, attributable to the lender's requirement that discount points be paid. These points adjust for the difference between the contract mortgage rate and the yield requirement of the mortgage lender, but they also represent a large front-end cost that must be paid by both buyer and seller. A mechanism that would be successful in reducing combined settlement costs would be to encourage lenders to charge mortgage rates that more closely approximate yield requirements. More selectively, this alternative suggests that borrowers should frequently be given the choice to reduce their settlement costs (and possibly the seller's) by agreeing to pay a higher mortgage rate.

As was pointed out in the introduction to this chapter, this alternative does not truly lower settlement costs but instead replaces the obligation to pay discount points at closing with an obligation to pay them off on a deferred basis in the form of a higher interest rate. Although this allows no true decline in the "present value" of settlement costs, it does permit buyers with little or no equity to more easily qualify for a loan. For these buyers, and particularly those that are young and have high earning potential, cash requirements for settlement will be reduced.

Advantages

Besides the benefits this alternative would provide buyers who otherwise would be unable to pass through the "equity barrier" (minimum down payment plus settlement costs) to qualify for home ownership, it would contribute to more simple and more understandable "packaging" of loan-related costs in the form of a single variable--the mortgage rate. The current system of explaining the cost of a loan allows lenders to quote financing charges in terms of a combination of an interest rate, discount points, and possibly other charges. However, the average home buyer usually cannot differentiate among these terms and identify the loan package that is most suited to his particular needs. Because of the difficulty in understanding the concept of an "origination yield" (as it was described in Chapter X of Volume II), many borrowers are not able to interpret the facts and make the decision concerning the selection of a lender that may be in their best interest.

It is difficult to estimate the number of households that cannot purchase homes because of inadequate cash. Many of those who would benefit from this alternative would be young and upwardly mobile, and in all likelihood would eventually be able to purchase a home. However, efforts to reduce cash requirements necessary at closing would make it more possible for those households to purchase a home, and it would contribute to making the process of selecting a mortgage lender more understandable.

Disadvantages

This alternative does not represent a substantial departure from current lending practices, because many lenders already provide the option of fewer points in exchange for a higher interest rate. Although we think it would be desirable to see this practice made more prevalent, difficulties are posed by two market influences. One is the current method of marketing homes for sale and of advertising available financing; the other is the influence which regulated FHA and VA rates have upon the market and upon consumer expectations.

Almost all lenders currently compete for customers by quoting mortgage rates which get substantially more attention than accompanying discount points or other fee requirements. Builders who have arranged permanent financing for their buyers also actively advertise available financing terms, and they frequently "buy down" mortgage rates (by paying discount points at closing) so they can offer below-market financing as an additional sales tool. As a result, home buyers have become increasingly aware of mortgage rates, but less aware of the additional costs or points that may accompany these rates. Without interpreting both in combination, the home buyer cannot recognize the "true" cost of mortgage financing.

This problem is made more difficult by the FHA-insured and VA guaranteed ceiling rates. These rates are subject to administrative policy decisions, and attempts have almost always been made to keep these ceiling rates as low as possible. However, FHA and VA rates that are below prevailing market rates must be adjusted for by the use of discount points. While buyers can be charged only a single discount point, there is no limit on the number of points that can be assessed the seller. As a result, a seller will typically adjust his selling price to recover the liability he may incur in paying discount points. To the extent that he is successful, these "settlement costs" paid by the seller are fully assumed by the buyer.

The VA guarantee and the FHA single-family insurance programs have fulfilled a significant social and economic purpose in this country. However, their ceiling rates effectively distort the interpretation by home buyers of true market financing costs. This encourages conventional lenders to adjust their rates downward (by charging discount points) so as to be more in line with FHA and VA rates. As a result, loan-related settlement costs are effectively increased. This alternative would, to some extent, circumvent this result and at least provide an option for borrowers to pay fewer points and a higher mortgage rate. A third difficulty in some states is posed by regulations or "usury" laws that place legal interest ceilings on mortgage interest rates. When market rates exceed these maximum rates, lenders wishing to make mortgage loans have no alternative other than charging points.

Evaluation

This alternative proposes that in some circumstances and at a borrower's request, portions of loan-related costs (discount points) could be reduced at the expense of a higher mortgage rate. This would: (1) reduce actual cash necessary to complete closing, and (2) result in mortgage rates that more accurately and completely describe financing charges. It would be difficult to require lenders to follow this alternative, although in some cases, lenders do make such an option available. However, to some extent, implementation would be difficult because it would take the form of increasing interest rates.

Lenders should be relatively indifferent to this option, except in situations where they find that home buyers selecting to pay the higher interest rate demonstrate a much higher loan turnover and therefore a much shorter expected loan life. To some extent, this alternative would be supported by administrative policy to adjust the FHA and VA rates more frequently and to keep them more in line with required secondary market yields. Regardless, we believe that this alternative would make it easier for home buyers to shop for lenders.

Alternative 4: Encourage Local Publishing of Mortgage Financing Costs Charged By All Local Mortgage Lenders

In selected areas of the country, there are publishing services that collect and distribute comparative mortgage financing terms that are updated on a weekly (or other frequent) basis. This information is distributed (through subscription) primarily to real estate agents, lenders, and other members of the industry. It contains such data as current interest rates and required points (for different LTVR categories), maximum loan amounts, other fees, and sometimes commitment terms for a large number of active mortgage lenders within a market area. It is, however, not always available to consumers at the retail level.

Similarly, local newspapers frequently publish somewhat less comprehensive information describing prime mortgage rates for small groups of local lenders. We believe that such information represents major contributions to better educated and more active shoppers for mortgage lending services, and that the availability of such information on a retail basis should be actively encouraged.

Advantages

The greater availability of information such as this strongly encourages more competition and more efficient market performance. The efficiency benefits both consumers and lenders. Through easy access to such published information, home buyers can become more aware of relevant terms in evaluating mortgage lenders. More importantly, such information can illustrate for consumers the extent to which rate variability exists within a market area. Many consumers lack either the technical ability or the familiarity to call lending institutions to inquire about their financing terms. However, publication of such information would bring attention to the extent to which rate variability does exist.

Lenders would also benefit from publication of current lending terms. They would be better able to "follow" actions taken by their competitors, and they would be less burdened by consumers "just shopping" for comparative rates. More importantly, this alternative would help generate greater market pressure on lenders whose rates might be well out of line from the rest of the institutions within a market area.

This alternative recommends voluntary media support in providing for an essential characteristic of a purely competitive market--perfect information. It would be relatively easy for HUD to design a basic format that might be used on a local basis for easy reporting purposes. Furthermore, the strong interest that is shown in matters relating both to consumer affairs and to housing and home purchase, suggests that adequate local support would be available for distributing this information. Local consumer affairs groups might cooperate in collecting and distributing this information, as might other groups with cooperative memberships.

Disadvantages

Any alternative that must rely upon voluntary or community action to be implemented faces the problem of being ineffective and non-uniform. Regulation could be passed requiring lenders to post frequent public notice of their financing terms, but this would meet with substantial industry opposition and would probably have little probability of success. If not coerced by regulation, lenders would not likely find difficulties with this alternative, and it would be welcomed by many real estate agent groups, particularly the smaller ones who might have less well developed ties with the lending community.

Evaluation

This is a relatively noncontroversial alternative, because it is likely that nearly all groups would benefit from public availability of this market information. We believe it would contribute to better disclosure, encouraging more direct shopping, and might put some competitive pressure on lenders whose rates are somewhat higher than the rest of the industry. Efforts to encourage the frequent publication of this information need not entail significant costs. HUD could act informally in select market areas to identify the effectiveness of alternative strategies to stimulate media disclosure. No additional regulation is necessary, and implementation could probably be achieved through local group initiative.

SUMMARY

An alternative that would reduce the discretion of the lender in either leading, recommending, or requiring certain settlement service providers suggests that lenders be required to provide home buyers with a choice among certain acceptable providers. Information comparing the fees charged by several lenders for a specific, common transaction would allow the home buyer the option to select the least expensive. In the two following chapters, this alternative is applied to the mortgage insurance and the title assurance industries.

Alternatives of this nature would play an important role in reducing the market power or influence typically given to the lender as part of his role in arranging for settlement and conveyance. However, even alternatives like these cannot guarantee that consumers will behave rationally or that the efficiency currently characterizing the origination through settlement process will not be compromised. We have found that the mortgage lending process is a relatively efficient one. Abuses do occur as a result of certain business relationships, but in general, extensive and possibly disruptive regulation would be needed to entirely eliminate such problems.

We believe that improvements to the current system of loan origination and financing would develop more easily and more efficiently out of improvements in the way that borrower and lender are brought together. Although loan-related costs are among the highest of those included in the settlement process, we think many represent legitimate costs of doing business. As a result, the lender is often forced to act as a conduit for loan-related expenses.

The alternatives presented in this chapter represent methods to bring more market information to the home buyer. Like those in the earlier chapter, they represent a set of measures that would promote the objectives of RESPA, and yet would require little market regulation.

ALTERNATIVES AFFECTING THE MORTGAGE INSURANCE INDUSTRY

The desirability of initiating actions to reduce the cost of private mortgage insurance is influenced both by the size of the population that would incur savings and by the expected amount of those savings. The requirement for private mortgage insurance is placed on a smaller population of home buyers than any of the other settlement components that are studied in this evaluation. Legal and title services are almost universally required in all matters relating to real property conveyance. Although many homes are bought and sold without the participation of a mortgage lender (cash purchases, seller financing, or purchase money mortgages), the average home buyer almost always requires mortgage financing from traditional sources. Despite the increase in for-sale-by-owner (FSBO) activity, real estate agents are still involved in an estimated 90-95 percent of residential transactions.

Mortgage insurance, however, is much more selectively a part of the settlement process. Only 34.7 percent of our sample of home buyers purchased mortgage insurance, and in market areas such as Boston and San Antonio, only 27 percent or less of the buyers were required by their lender to make such a purchase. A number of factors including both economic fluctuations and government regulations influence lending requirements for mortgage insurance. The Federal Home Loan Bank Board has recently proposed new regulations requiring mortgage insurance only on conventional financing of loans in excess of a 90 percent loan-to-value ratio (instead of the current requirement on all loans with less than a 20 percent loan payment). Despite the impact that this change might provoke, privately insured conventional financing is likely during the 1980s to regain that significant portion of the combined insured/guaranteed market that it forfeited during 1979 due to a contraction in conventional financing activity (see Volume II, Exhibit IV-5).

For that group of home buyers required to purchase mortgage insurance--and these are predominantly younger households lacking large down payments, VA eligibility, or an interest in the FHA program--mortgage insurance can represent a large cash requirement at time of settlement. Assuming an average $60,000 loan, an annual renewal policy for the popular 90/20 (for a 90 percent loan-to-value ratio loan, insurance coverage is provided for the top 20 percent of the claim amount) plan would require $300 at settlement plus up to two months for escrowed prepaid premiums ($50); for the 95/25 policy that is typically required of those unable (or unwilling) to make a full 10 percent down payment, $600 plus prepaid premiums may be required. However, under those circumstances where single premium policies are required, the cash requirements at closing for mortgage insurance may range up to $1,425 (see Exhibit III-1).

Use of the single premium policies has generated the greatest amount of criticism in the past with regard to costly settlement expense, and both the lending and the mortgage insurance industries have demonstrated a positive response. Our survey indicates that the single premium plan is now used only 5 to 10 percent of the time, and lenders who earlier found the single premium policy desirable now do so with decreasing frequency.

EXHIBIT III-1

PREMIUM REQUIREMENTS FOR MORTGAGE INSURANCE ON A TYPICAL $60,000 LOAN: RENEWAL AND SINGLE PAYMENT PLANS

	90% LTVR; 20% COVERAGE (90/20 POLICY)		95% LTVR; 25% COVERAGE (95/25 POLICY)	
	RENEWAL	SINGLE (1)	RENEWAL	SINGLE (1)
Prepayment Required at Settlement	$300	$1,080	$600	$1,425
Annual Renewal Premium	$150	–	$150	–

(1) Premium required in most states for 10 year single premium policy by at least half of the insurers.

Similarly, the average costs for renewal plans have declined somewhat due to occasional examples of price competition, but the basic $300 cost represents an approximate average or expected cost for the first year's mortgage insurance premiums that are required at settlement.

This chapter investigates and proposes alternatives that could reduce the cost of mortgage insurance in those situations where it is required. As is the case for alternatives to current loan origination and financing practices, alternatives to current insurance practices can be developed through either specific price regulation or through actions to encourage greater price competition. The next section of this chapter provides a more detailed discussion of alternatives requiring amendments to the McCarran-Ferguson Act that would be necessary to secure nationwide price regulation of title insurance premiums. Without similar action or the exclusion of mortgage insurance from the McCarran-Ferguson Act, a state-by-state review of mortgage insurance pricing would be necessary, would require significant effort, and would probably result in a slow and a non-uniform process.

We believe that alternatives designed to increase price competition among insurers will be more efficient than regulation for reducing costs for mortgage insurance at time of settlement, and that such alternatives will also provide more immediate nationwide results. The five alternatives that follow are presented in order of their ease of implementation. They are followed by an alternative that directly addresses greater and more direct regulation at the state level aimed at reducing current costs of private mortgage insurance, and by one that suggests an open competition for mortgage insurance pricing.

Alternative 1: Require Greater Disclosure By Lender Concerning Mortgage Insurance Policies, Forms, And Premiums

Without a substantial change to the current process of selecting a mortgage insurer, the lender will continue to make or at least strongly influence that selection. Though the present system, characterized by reverse competition, permits some abuses, it similarly permits some operating efficiencies. This alternative would not encourage insurers to market themselves directly to home buyers in order to circumvent those current relationships that develop between lenders (and in some cases, real estate agents) and mortgage insurers. Instead, it would require greater disclosure of certain matters relating to the cost, purchase, and termination of mortgage insurance. Such disclosure would be, in many cases, adequate to prevent many potential abuses and may increase consumer pressures for more price-competitive behavior among providers.

This alternative suggests that a number of facts and/or characteristics concerning mortgage insurance be presented to the home buyer early in his search for a mortgage lender. The timely disclosure of this information is very important, and could be conveyed in a more complete and detailed special information booklet (SIB) if responsibility for its distribution were given a provider other than the mortgage lender. Because this information is relevant to only a small portion of total home buyers, a special booklet might be designed that focuses only upon matters relating to mortgage insurance (possibly as an insert to the SIB). It need not be limited to conventional loan applicants, and could compare the relative advantages and disadvantages of FHA, VA, and conventional loans for those home buyers seeking high LTVR loans.

A number of facts concerning mortgage insurance are important and should be better presented to home buyers. These represent a minimum set of information that we feel is necessary to avoid misunderstandings, mistakes, and potential abuses in the use of mortgage insurance and in the selection of insurers, the type of coverage, and the premium payment plan. The following information should be included:

- Prices are not uniform across insurers, and some cost savings can be achieved by shopping for the least expensive insurer that is acceptable to the lender.

- A down payment of at least 10 percent will result in a large proportionate decline in the amount of the first year premium that is required at closing.

- A down payment of at least 10 percent may also result in a reduced mortgage rate from the lender.

- Alternative insurance premium payment plans do vary, and their relative attractiveness is influenced by the mortgagor's expected term of home ownership.

- The conditions allowing mortgage insurance coverage to be terminated can vary by lender, and the home buyer may wish to select a lender who offers the most favorable terms for policy termination.

- Refunds for unexpired prepaid insurance premiums represent an asset to the home buyer, and he should be assured that they will be promptly refunded to him (preferably by the insurer) at the time the insurance is terminated or the loan is paid off.

- Conventional mortgage insurance may provide a less expensive mechanism than FHA insurance for both purchasing a home and renewing required insurance.

Advantages

This alternative is one that can be very easily implemented with no required changes in current regulations. If this information were made a part of a revised SIB, then it could be disseminated as a part of the existing system of advance disclosure. No additional responsibilities would necessarily be required of any settlement service providers, short of an obligation by both lenders and real estate agents to provide explanations and to answer questions that this new information would elicit from home buyers. If this information were made a part of a separate consumer information booklet, then it could be distributed at the same time as the SIB, with little additional required effort.

We feel that despite current expectations of RESPA, borrowers are relatively uninformed of the requirements for mortgage insurance, and this "mystery" has reinforced the position of lenders in often dictating the selection of the insurer, the coverage, and the premium payment plan. Advance disclosure of this information would alert home buyers to ask the right questions and would possibly allow them to eliminate those situations where actual abuse occurs or where a concern for consumer interests may be compromised.

In some cases, this new information will make the selection of a mortgage lender partially contingent upon his mortgage insurance requirements. This should encourage greater competition among lenders. More importantly, it will put some pressure upon lenders to become more sensitive to the cost of mortgage insurance and it will require that many lenders use some insurers whom they might otherwise not use.

To the extent that lenders will become somewhat more competitive in establishing mortgage insurance requirements, insurers themselves will also become somewhat more price competitive. A move in this direction is likely to improve the market prospects of those few, small insurers who are presently leaders in price reductions. It may also encourage the larger, more dominant firms within the industry to reduce their prices to retain market share.

Finally, each of these items of information is intended to reduce the cost of mortgage insurance at some time during the term of home ownership (at settlement, during ownership, or at eventual sale). To the extent that they reduce the cost of settlement, they are likely to be welcomed by most mortgage lenders, who have an increasingly difficult problem in qualifying applicants for the loans they are requesting. As a result, lenders may often find this additional disclosure desirable, and in some cases, it may actually reduce their own responsibility for explaining mortgage insurance requirements.

Disadvantages

Supplementing consumer information will not be supported by all lenders. This disclosure will require that lenders become more knowledgeable and better prepared to discuss many new issues with home buyers. They may resist this. It seems, however, that the industry has looked somewhat positively upon fostering better consumer education concerning the use of mortgage insurance, and lenders may support any move that would encourage the use of conventional mortgage insurance in the settlement process. The larger mortgage insurers may oppose this alternative because it increases competitive pressures and it may force insurers to lower prices. This, of course, is a primary advantage of the alternative from the consumer's perspective.

Finally, this alternative involves either the expansion of the present SIB or the development of a new booklet designed specifically to address issues related to mortgage insurance. We think the associated costs would be relatively small. Practices relating to the purchase of mortgage insurance are fairly consistent across states, and a booklet could be written that is concise, focused, and yet specific to nearly all local requirements.

Evaluation

This alternative could be implemented with relative simplicity and would involve little risk of negative reaction if HUD included this information in a revised SIB. There is a high probability that this method of advance disclosure would motivate both better understanding of mortgage insurance and more comparative shopping that is sensitive to the costs of mortgage insurance. The cost of developing a new information booklet would be relatively minor when compared to the contribution it would make to consumer information.

Alternative 2: Require Options to Single, Prepaid Policies

In those instances where single premium policies are required by certain lenders, the mortgage insurance premium required at settlement can be more than twice as high as where annual premium policies are used. The elimination of a lender's requirement for this single payment policy as the only payment plan offered would represent a step toward substantial but selective reduction of insurance premium costs.

Advantages

In some cases, home buyers prefer to prepay all their mortgage insurance premiums at settlement. By doing so, they seek to: (1) maintain as low a monthly payment as possible, and (2) eliminate the liability of a monthly mortgage insurance premium. We do not believe these consumers should be denied this option. However, some lenders may require that a home buyer fully prepay the policy so as to ease the servicing requirement that would be made of the lender in collecting, escrowing, and prepaying subsequent annual premiums. We feel that such a requirement is insensitive to the buyer. The problem could be avoided by requiring lenders to provide home buyers an option to select either a single or a renewal insurance payment plan.

More than two-thirds of the lenders we interviewed indicated that they required single premium policies 10 percent or less of the time. As a result, most lenders would have a relatively easy time adopting such a requirement because they would undergo only a small change in their mortgage insurance procedures.

Our surveys focused primarily on the lending requirements of institutions in the urban and suburban areas of major metropolitan cities. In some other less populous areas, single premium policies may be more prevalent, and many home buyers in those areas are less likely to be aware that alternatives requiring less cash at closing are available.

This alternative would also reduce the severity of problems caused when lenders withhold refunds for prepaid, unearned premiums. None of the lenders to whom we spoke indicated that they felt this represented a recurring abuse. Nonetheless, home buyers will be likely to incur less of a loss as more are aware of and take advantage of annual renewal plans.

Disadvantages

Three difficulties are posed by this alternative: (1) it does represent an additional servicing effort for some small lenders; (2) it may be difficult to comprehensively legislate; and (3) it could be difficult and burdensome to enforce. Some institutions that are only infrequent mortgage lenders could legitimately claim that renewal mortgage insurance payment plans do involve a loan servicing effort that they are unprepared to provide. In extreme cases, such institutions--such as small, non-urban commercial banks--might eliminate high LTVR mortgage lending entirely rather than fulfill this added requirement. Other institutions might reason that their additional efforts would require that higher interest rates (or other charges) be assessed to high LTVR borrowers, and in these situations, the benefits of a lower insurance premium payment might not outweigh other related costs.

We believe that this disadvantage would apply to only a small group of lenders and would impact a substantially smaller proportion of mortgagors. A more difficult set of problems with this alternative concerns comprehensive legislation and adequate enforcement capacity. Members of the Federal Home Loan Bank System and of the Federal Reserve System could be required to provide premium payment alternatives in those cases where they are not currently doing so, and both boards could adopt policies that would at least strongly encourage, if not ensure, compliance. Although burdensome, such policies could require that another form (acknowledging the home buyer's choice of premium payment plan) be signed prior to or at settlement. We recognize that this alternative may complicate decision making by the borrower.

Greater problems, however, would be encountered in attempting to secure changes in requirements governing mortgage bankers and certain state chartered commercial banks, savings banks, and S&Ls. Efforts to encourage FNMA and FHLMC to require all seller-servicers to provide mortgagors a choice would be useful, but would not preclude the need to have all state chartered institutions, which are not subject to federal regulations, governed by new regulations from within each state.

Evaluation

We believe that it is not necessary to ensure that all lending institutions are influenced by new requirements to offer a choice of mortgage insurance payment plan. Savings banks and commercial banks account for relatively little high LTVR conventional mortgage lending, and many of those institutions that do require mortgage insurance may be FHMA/FHLMC seller-services. Instead, selective measures impacting only FHB System members and/ or only FNMA/FHLMC sellers, for instance, would be desirable and would help decrease the frequency with which certain lenders require single premium plans. This alternative would likely meet only little industry resistance because few lenders now require single premium plans for all their borrowers; other lenders would have a relatively easy time adapting to this change.

We believe, however, that this alternative has a relatively small impact upon most mortgagors. If the numbers in our sample are nationally representative, then at most 10 percent of the 34.7 percent of home buyers purchasing mortgage insurance would be impacted. This is less than 4 percent of the total home buying population, and many of these might, in fact, desire to purchase mortgage insurance by the single premium plan. Nonetheless, the savings could be substantial for this small group. Although this alternative may lack the benefits to justify a separate regulation, we feel it could be easily accommodated and should be considered part of other changes that might be initiated.

Alternative 3: Require That Mortgagors Be Given a Choice From Among a Select Group of Insurers

The requirement that home buyers be allowed some discretion in the mortgage insurance premium payment plan does eliminate some areas of potential abuse of consumer interests. However, a more broad-sweeping remedy to many of the problems associated with the reverse competition that characterizes the relationship among lender, insurer, and consumers is to assure that the home buyer has an active voice in the selection process. This could be accomplished by requiring that all home buyers who need mortgage insurance be given a choice of approximately five different insurers who are licensed to do business in a particular state.

Advantages

This alternative would represent a significant change in the current process of selecting insurers. First, it would increase the number of insurers with whom lenders do business. Nearly 20 percent of the lenders in our sample indicated they had master policies with only one to three insurers. If, for instance, a minimum selection of five insurers were required, then this measure would contribute to deconcentrating the new market share of firms within the industry. Furthermore, it would virtually prevent an insurer from developing and maintaining exclusive or near-exclusive relationships with lending institutions. Although such relationships were not deemed to be very effective tools of market control, they do contribute to maintaining the concentrated nature of the industry.

Reducing, or actually eliminating, the lender's selection of the mortgage insurer diminishes the influence of reverse competition, and the settlement service markets should become more price competitive. If the consumer is given a choice from among five or more insurers, the lender can no longer ensure that a certain volume of loans will be delivered to insurer X. Nonprice competition would thereby become a less effective method of developing market share, and this might encourage the industry to more enthusiastically compete on the basis of price.

Finally, this alternative would allow the home buyer a level of discretion that may be adequate to solicit more prevalent price reductions from the industry. It would be unnecessarily burdensome to require that each lender make available a choice from among all insurers licensed in a particular state. That would be inefficient for most lenders, and would not necessarily provide marginal advantages to the consumer. However, when even a relatively uninformed home buyer is faced with a choice from among five insurers, all of whom are acceptable to a lender and about whom he knows nothing, his own selection process should naturally be based on the question, "Which one will cost me the least?" As a result, a degree of concern for price is introduced and the home buyer is better assured that he is not paying for unnecessary services.

Disadvantages

Although this alternative substantially reduces the noncompetitive market influences that accompany reverse competition, a number of factors reduce the overall effectiveness of the mechanism. First, it encourages some insurers to attempt to market or at least advertise directly to the consumer. This might shift the current marketing strategy of the industry, and encourage firms to incur greater marketing expenses. Seven of the fourteen mortgage insurers we interviewed indicated that they felt marketing and overhead expenses would increase dramatically if insurers were required to promote themselves directly to consumers; only one felt these costs would not be passed on to the consumer.

Second, this alternative would favor those larger, established insurers whose name is already familiar to many consumers, thereby offsetting any advantages resulting from a deconcentration of the industry. Third, the selection of a reasonable number of insurers poses a potential problem. If it were decided that five or six firms provide an adequate field for consumer choice, this number might become some sort of "ceiling" within the industry. More than 30 percent of the lenders whom we intereviewed indicated that they maintained master policies with more than seven insurers. These lenders might reduce the number of insurers whom they would use to the number they are required to present to the buyer; by so doing, they might eliminate the smaller firms, resulting again in a greater concentration.

Also, this plan does not guarantee that the insurers who are currently recognized as "price cutters" within the industry would be included in the select list presented to the home buyer. In some states where nearly all insurers are licensed, the lender might select those larger, established firms that have shown little initiative in price reductions. As a result, the number of insurers presented to the borrower is very critical to the effectiveness of this alternative. Requiring too large a number may cause legitimate complaints from the lending industry, and too small a number of alternative insurers may provide little actual choice in the price of insurance coverage.

Finally, the success of this plan is contingent upon the extent to which the lender actively explains the differences among a group of insurers. Because of the significant range in the levels of coverage and the variety of premium payment plans, this alternative requires that lenders both: (1) understand the full range of alternatives, and (2) actively represent that range to the home owner. There are no easy mechanisms to ensure such cooperation from the lender. The additional burden placed upon the lender may actually represent a disincentive to abide by the spirit of the alternative. As a result, there is little assurance that the intended advantages will be realized.

Evaluation

This alternative is one of the more difficult to evaluate because of the inexactness in assessing the relative merit of its advantages and disadvantages. To be implemented, such an alternative would require an amendment to RESPA or other forms of legislation, and compliance could be fairly well assured by introducing to the settlement process the completion of another form--this one acknowledging the homer buyer's active role in the selection process. However, although implementation poses no significant problems, it does not promise a high probability of success. We would recommend that attempts be made to test this alternative for effectiveness on a pilot basis, prior to any serious national program, with the assumption that the alternative be shelved if the results are not beneficial to consumers and the industry.

Alternative 4: Encourage Media Coverage of Rate Structure of Licensed Insurers

As with the mortgage lending industry, a positive step toward effective consumer information would be to publish the costs of selected mortgage insurance policies for all firms licensed within a state. Such information is readily available from the Office of the Insurance Commissioner within each state, and with the exception of states in which rates are fixed (e.g., Texas), presenting these data could easily and inexpensively help to encourage consumers to shop for inexpensive insurers and for lenders who work with those firms.

Advantages

This alternative would work in two ways to encourage greater price competition within the industry. First, it would publicize the names of those insurers who offer lower prices. Second, it would make insurers more sensitive to price competition and it might encourage more frequent conformance to the lowest posted industry prices.

This alternative could be relatively easy and inexpensive to implement. No regulation would be necessary, because it could be accomplished through voluntary rather than coercive actions. The Department of Housing and Urban Development could design a straightforward and unambiguous format that could be used at the state level. Representatives of each state insurance commission could be requested to then provide information on each licensed insurer. Without the voluntary cooperation of the insurance commission, requests could be made of consumer groups. If necessary, small grants could be provided to stimulate otherwise inadequate interest. Such an incentive might be necessary in states where filings are not mandatory (e.g., California).

Efforts would have to be made to keep the information up to date. However, many insurers might voluntarily keep a public source of rate information current if they are attempting to match their competition. We have seen no recorded evidence of rate increases. Should they occur, rate filings with the insurance commission would have to be monitored in order to follow all changes accurately.

Compiling this information in an organized fashion represents only half of this alternative. Media coverage must also be encouraged. In most urban areas, a variety of residential real estate publications might find it desirable to print and distribute such information. Local real estate sales magazines, newspaper columns, real estate agent services, and consumer affairs groups are other potential means of publicizing such information. Lenders might even cooperate in distributing such lists when the information shows that they accept insurance coverage by firms demonstrated to be among the least expensive.

Disadvantages

The primary disadvantage of this alternative is that it must rely upon voluntary action. However, both a strong consumer movement and a growing interest in housing and home ownership suggest that adequate voluntary initiative would develop. HUD may be required to sponsor initial efforts in developing a basic format and contacting responsible parties who would contribute to carrying out a public information campaign, but such efforts would be relatively small. It is unlikely that industry groups would actively work against this effort.

Evaluation

This alternative represents a very low-cost, indirect intervention into the existing market process. It requires no new regulations and warrants no enforcement, yet it could contribute substantially to a body of public information that is presently small. The effort need not be carried out on a national scale; local initiative or that provided by the state insurance commission would be adequate to implement this alternative. We feel that a commitment to this plan could be easily incorporated into a more comprehensive national consumer information and settlement cost disclosure effort, which would provide substantial benefits without direct market interference through regulation.

Alternative 5: Require Lender to Partially Absorb Mortgage Insurance Costs

All of the earlier alternatives have represented attempts to increase market information and to shift to the mortgagor more responsibility for the selection of the mortgage insurer. If those alternatives were found to allow inadequate improvement in the mortgage insurance purchase process and inadequate opportunity for the reduction of cost, then stronger regulatory measures may be appropriate to improve market performance. This alternative outlines such methods of intervention, but it is substantially more difficult to implement, can be expected to generate substantial industry resistance, and may encourage reactions or responses that are difficult to anticipate.

Chapter XI of Volume II indicates that price competition is at a relatively early stage within the mortgage insurance industry. While some firms offer premiums that may be as much as 30 percent lower than the average cost of first year coverage for the industry (see Exhibit XI-12 for a comparison of costs for a 90/20 annual premium policy), most firms maintain relatively inflexible prices. As a result, only limited pressures to further reduce prices emanate from the current level of limited price competition.

The impediment to greater market competition rests with the selection process. It is nearly always made by the lender, and he is relatively insensitive to actual cost. Even considerably greater levels of disclosure and consumer information would be inadequate to motivate the lender to act in a way that would encourage greater price competition.

One method of so motivating the lender would be to require that he pay for the difference between the cost of a mortgage insurer whom he would select, and the cost required by the least expensive (or a less expensive) insurer licensed within a particular state. In other words, a "base insurance cost" could be defined for each type of mortgage insurance policy within each state. This cost would then represent the "ceiling" charge that the mortgagor could be assessed, and the lender would be free to select any mortgage insurer he might wish, recognizing that any premium which that insurer charged over the "base cost" would be paid by the lender.

Advantages

This alternative would avoid many of the disadvantages that currently accompany the selection process, and it could do so without relying at all upon a better informed or rational consumer. Almost all other alternatives have attempted to achieve lower prices indirectly through the process of better educating the home buyer and encouraging him to shop. This alternative, however, is more challenging in dealing with mortgage insurers than with any of the other settlement service providers, because the relationship between the lender and insurer is better defined and sometimes less flexible than the one between the lender and other providers. A primary advantage of this alternative is that home buyers need to know nothing about mortgage insurance. No efforts need be expended in education or disclosure because such additional information would provide the consumer no advantage. Instead, the cost he would pay is "fixed," and he would be indifferent among all insurers, regardless of their true cost of insurance.

Second, this alternative would achieve cost savings for the home buyer without directly impacting the current pricing policies of the industry. Insurers would be free to set their prices at any level they wish. This alternative, however, eliminates the problems of reverse competition, and introduces normal price elasticity to the market for mortgage insurance. As a result, it is likely that more firms within the industry would reduce their prices, but they would do so in response to more normal market conditions, and not as a result of price regulation or other market interferences.

This alternative would also circumvent the need to directly regulate any of the mortgage insurers, who, by nature of the McCarran-Ferguson Act, are subject to state and not federal regulation. As a result, implementation would be greatly simplified; it would not, however, be without its problems. The implementation of this alternative would require the additional regulation of mortgage lenders, and major elements of this group industry--members of the FHLB system and nationally chartered commercial banks--could be influenced in a relatively efficient fashion. Broader regulation could be achieved through modifications or additional requirements placed on loans sold to FNMA or FHLMC, but it would remain a more difficult task to enact regulations governing all state chartered commerical banks, savings banks and S&Ls.

A fourth advantage of this alternative is that it would substantially encourage the development of a less concentrated industry. It would promote a more even distribution of new industry growth, because there would be a substantial incentive for lenders to direct new business to the less expensive insurers, who are presently smaller firms that are struggling to develop a greater market share.

Finally, this alternative would correct current problems associated with the delivery by insurers of free ancillary services in exchange for insurance business which is paid for by the home buyer. An established "base cost" for mortgage insurance might represent the price charged by those small insurers who provide few additional services. As a result, lenders could "choose" to purchase ancillary services by selecting any insurer who would provide those services. Any premium, however, which that insurer would charge would be paid by the lender who uses the service. In this same way, a lender could express his preference for those mortgage insurers with greater reserves and capital, and therefore greater financial security. This preference, however, would become subject to market influences and would be available only to those lenders willing to pay the additional premium necessary to exercise it.

Disadvantages

A significant disadvantage of this alternative is the difficulty in defining the "base price" for a mortgage insurance policy that would apply within a given state. It is difficult to remove all elements of arbitrariness from this decision, and at the same time, it is difficult to be entirely equitable. Relationships influencing some of the smaller firms may have a substantial influence upon reducing their cost structure; as a result, selecting the price of the least expensive firm as the "base price" may be less than fair to the other insurers, and it may place too heavy a cost upon the lenders who do not select to always do business with that least expensive insurer. At the same time, the selected "base price" should be one that is no higher than the price of the least expensive insurer, because such a situation would encourage that insurer to increase his price to the posted "ceiling."

Evaluation

We feel that this alternative has significant merit because it represents a mechanism that is relatively effective at reducing costs; it removes all consumer responsibility for acting upon market information, and it can be implemented without significant market intervention. It is likely that this alternative would allow the industry to become more competitive because advantages that are currently made available by the large insurers would now have to be purchased by lenders in order to be enjoyed.

One of the attractive features of this alternative is that it may represent the only incentive necessary to effectively reduce the cost of mortgage insurance, and as a result, it represents a modification of the lender-pay alternative that is discussed more comprehensively in the following chapter.

Alternative 6: Encourage State Insurance Commissions to Evaluate More Closely the Extent to Which Insurance Premiums Might Be Out of Date

Each of the prior alternatives defines ways to reduce prices for mortgage insurance by increasing market information and price competition. Another alternative relies upon the regulatory process rather than upon an efficient and competitive marketplace. State insurance commissions could take a more active and critical role in evaluating premiums charged within their respective states. This alternative places a greater level of responsibility upon the insurance commissions to assure fair and equitable pricing by monitoring and evaluating premium filings.

Our discussions with representatives of state insurance commissions in each of the ten states where we conducted interviews indicated that there is a relatively tolerant attitude regarding the regulation of mortgage insurers. There are a number of reasons that account for this. First, private mortgage insurance represents a relatively small line of insurance premiums written or earned. As a result, the potential gain to the citizens of the state from investigating mortgage insurance is small.

Second, many of the representatives of state insurance commissions demonstrated a lack of familiarity with the private mortgage insurance industry. It is not a line of insurance with which they are concerned regularly. As a result, many commissions may be less likely to identify and investigate questionable practices. Third, losses have been relatively small, and this is sometimes interpreted as a sign of prudent management.

Finally, relatively few consumer complaints have been registered with insurance commissions with regard to mortgage insurance. When compared to FHA insurance premiums, the price of private mortgage insurance is often considered reasonable.

However, the state insurance commissions are in a critical position to provide a closer scrutiny of mortgage insurance premiums. Efforts could be made to place greater responsibility upon the insurance commissions to question the current pricing structure of mortgage insurance.

Advantages

State rate regulations could give the advantage of achieving results in reducing the costs of mortgage insurance premiums. There is no need to rely upon an efficient marketplace, and no burden of responsibility is placed upon the consumer to act rationally or knowledgeably. This alternative provides the benefits of efficiency, and it is as effective as are a state's surveillence and enforcement procedures.

A state insurance commission could analyze several aspects of mortgage insurance premiums. These many include: (1) the adequacy or excessiveness of the 50 percent reserve requirement; (2) the actual level of mortgage insurance premium prices for all or selected categories of insurance coverage offered by different insurers; (3) the "fairness" of allowing insurers to deliver to lenders a broad range of ancillary products at no charge, while the actual "cost" of these services is borne by the consumer; or (4) the industry's actual loss experience since 1957. These items would provide state insurance commissions with the opportunity to define "fairness" or determine the extent to which current premiums are actually high. To the extent that such premiums are deemed to be higher than necessary, these methods of evaluation would provide a rationale for establishing ceilings or for reducing premiums so as to make the requirement for mortgage insurance less costly.

Disadvantages

A difficulty posed by this alternative is that it requires voluntary cooperation by state insurance commissions to more actively regulate prevailing insurance premiums. Many of the insurance commissions have demonstrated no interest in allocating their limited resources to more closely evaluating premiums within the mortgage insurance industry. Absent amendments to the McCarran-Ferguson Act, the federal government can only encourage such cooperation.

Were a national study completed which evaluated the premium structure of the mortgage insurance industry, difficulties could arise if states were to interpret the results differently. This might result in less uniformity across states than currently exists. Under such conditions, "cost" assumptions that would be critical in defining "reasonable" price levels would be distorted as a result of those prices being non-uniformly applied across states.

Although it is desirable for state insurance commissions to be able to evaluate rates filed within their states against some "reasonable" standard, it is extremely difficult to define such a standard for two reasons: (1) the differences in performance within an industry that contains both large, established firms and firms that are relatively small and have significantly different operating efficiencies; and (2) the difficulty in defining a level of losses which firms should be expected to absorb successfully.

A substantial problem in rate regulation is posed by the need to define reserve requirements that are able to withstand an economic catastrophe of some well-defined severity (where the critical factor may be either: (1) the percentage of premiums that are reserved, or (2) the amount of the premium that can reasonably be charged consumers). In other words, an answer must be provided to the question, "How safe is safe?" This problem exists for all lines of insurance.

These are very difficult economic questions, and they reflect the problems that currently face state insurance commissions in attempting to differentiate between acceptable premium levels and those that might be interpreted as inadequate or excessive. A reluctance to grapple with these questions has caused many state insurance commissions to be relatively passive in approving rate changes, and in many cases it has encouraged the commissions to be more concerned with the adequacy of reserve levels than with high prices.

Evaluation

Despite the difficulties that are posed by attempts to define excessive premium levels, we believe that a comprehensive study of industry pricing experience and pricing assumptions would contribute significantly to a better overall understanding of the private mortgage insurance industry. However, even without such a study, efforts to require more active evaluation of insurance by state insurance commissions would provoke a very positive influence upon the industry. However, it cannot be assumed that such scrutiny will result in lower prices.

The State of Texas is the only jurisdiction that we studied where premium prices were fixed by the state and were not subject to prices filed at the discretion of the mortgage insurers. There is no evidence to indicate that prices are lower in Texas due to this more active involvement in pricing matters. For many categories of mortgage insurance coverage, prices were actually higher than those available in other states. This suggests that more conservative assumptions are used in Texas in defining premium levels that are considered adequate.

Other states might adopt similarly conservative standards in interpreting the results of a comprehensive study of industry pricing, and as a result, lower prices due to such an evaluation cannot be assured. However, we believe that both the industry and consumers would benefit from closer scrutiny by state insurance commissions, and more forceful actions on their part in challenging current premium levels might make a substantial contribution towards encouraging more active price competition among mortgage insurers.

Alternative 7: Adopt Open Competition for Mortgage Insurance

The most salient characteristic of mortgage insurance pricing (discussed in Chapter XI of Volume II) is the near price uniformity among the larger companies for mortgage insurance. The prevailing level of mortgage insurance prices, which we believe is above that which would exist under more price-competitive conditions, is related to the relative insensitivity of lenders to price but also, we believe, to the existence of insurance rate regulation. Most states have some form of rate regulation, ranging from the file and use (or use and file) form used in many states, to explicit rate regulation, as is used in Texas. Some states neither regulate mortgage insurance, nor have any filing requirements--these are open competition states. The requirement for an insurer to publicly file its rates with the insurance commission makes those rates known to all competitors and to insurance officials in other states. The filing requirement could inhibit insurers from reducing rates in some states, as it invites counteraction from competitors and pressure from officials in other states to lower rates there too. Such a requirement could inhibit active price competition.

This alternative calls for states to adopt open competition for mortgage rate insurance. Mortgage insurers would be regulated in terms of reserve requirements and capital adequacy. There would be no regulation of mortgage insurance premiums nor a requirement that they be filed with any state regulatory authorities.

Implicit in the concept of open-competition for any line of insurance is the realization that the McCarran-Ferguson Act would no longer be applicable. That Act exempts insurance from antitrust laws provided that the rates are regulated by the states. Under open-competition, rates are not regulated; therefore all of the antitrust laws apply automatically. By exempting a particular line of insurance from the Act's coverage, the Federal Government actually put insurance under an opencompetition system without state action.

Advantages

This alternative should be considered in consonance with Alternatives 1, 3, and 4. Those alternatives seek to better inform the home buyer about mortgage insurance alternatives and prices, and to increase pressure on mortgage insurers to act in a more price-competitive fashion. Open competition makes it easier and more likely for insurers to respond to price sensitive consumers by reducing their premium rate from industry-wide levels. There is ample evidence that insurers now compete primarily by offering lenders additional services and through marketing campaigns geared mainly at their sources of referral--lenders and realtors. Encouraging states to adopt an open competition policy for mortgage insurance could help focus the mortgage insurer's attention on the ultimate consumer, and assuming the consumer were better informed about insurance options and prices, encourage him to consider price reductions as a means towards increasing his market share.

Disadvantages

The mortgage insurance market is characterized by uninformed consumer ignorance and reverse competition. While rate regulation and rate filing requirements have not led to increased rate competition and lower premium rates for the home buyer, their removal could result in serious consumer abuses. Many consumers will likely continue to use realtors and lenders as sources for referral for mortgage insurance. In fact, those who require mortgage insurance are more likely to be first-time buyers with no previous experience in purchasing settlement services. In the absence of some regulatory involvement in rate determination, some consumers may be taken advantage of and referred to high price mortgage companies, which may be owned by the referrer or may provide some commission or other fee to the referring provider. Unless the alternatives implemented radically change current market characteristics for mortgage insurance, the number of consumers potentially subject to pricing abuses under open competition by providers may be quite numerous. Implementation of the open competition alternative may increase rather than decrease mortgage insurance rates for a large number of home buyers.

Evaluation

Unlike title insurance, the consumer has no direct interest in mortgage insurance characteristics other than its price. Consequently, we believe this alternative has considerable promise of helping create a more price-competitive atmosphere and of lowering mortgage insurance costs if it is implemented along with Alternative 1 and, perhaps also Alternatives 3 and 4. If implementation of these alternatives results in a more price-competitive atmosphere, where rates charged by some large insurers are lower than those currently prevailing, it is unlikely that a significant portion of home buyers will be charged rates that are higher than those in use today. We also believe that changing to an open competition regulatory environment increases the likelihood that alternatives which better inform home buyers about mortgage insurance policies will result in lower premium rates. We therefore recommend that this alternative be considered for implementation along with Alternatives 1, 3 and 4. Note that Alternatives 6 and 7 are mutually exclusive.

SUMMARY

Among the four industries studied, changes in the regulatory or competitive environment for private mortgage insurance may affect the smallest number of consumers, because most home buyers are not required to buy private mortgage insurance. Nevertheless, we believe mortgage insurance rates can be reduced if some of the alternatives advanced here are implemented. We tend to favor alternatives that seek to better inform the consumer about mortgage insurance and available prices and to promote more active price competition. In our view, this is more desirable than seeking tighter and more effective rate regulation from state regulatory agencies.

ALTERNATIVES TO THE TITLE INSURANCE AND CONVEYANCING INDUSTRIES

This section provides a discussion of a wide ranging set of alternatives to the present ways title assurance and conveyancing services are regulated. The alternatives which will be analyzed range from Federal Government regulation of rates to some product characteristic alterations. The industry analysis presented in Chapter XII of Volume II indicates that the provision of these services is inefficient and not serving consumers well. Therefore, alternatives to the present system should be considered.

In 1945, the McCarran-Ferguson Act conferred on states the right to regulate all lines of insurance. The Act states that lines of insurance are exempt from prosecution under the Sherman, Clayton, Federal Trade Commission, and Robinson-Patman Acts "to the extent that business is regulated by state law." In other words, insurance industries are not subject to Federal antitrust laws if, but only if, their rates and practices are regulated by each state. Every state now has a Department of Insurance and an insurance commission that discharges this responsibility.[1]

This section is divided into three basic types of problems which need to be addressed in the provision of title assurance. The first problem is the generally high level of prices. Three types of regulatory approaches to pricing will be analyzed.

The second problem area is that of tied relationships, including controlled business and lender-required attorneys. The relationships between title insurance providers and referrers (lenders, attorneys and real estate brokers) has often been blamed for high industry costs that result in high consumer prices. However, as shown in Chapter XII of Volume II, high charges for title assurance and conveyancing services can exist whether tied relationships are prevalent in an area or not. Tied relationships, however, will be addressed as a problem in its own right because of the apparent conflict-of-interest issue they present.

The third general problem area is that of structural inefficiencies with the title insurance product itself. The recommended changes in this area could be made either by the industry or as part of a governmental regulatory program.

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[1] See Ernest F. Roberts, Jr. et al., Public Regulations of Title Insurance Companies and Abstracters, (Philadelphia: Villanova University Press, 1961). Commissioned by the American Title Association.

UNREASONABLY HIGH PRICES

Title insurance, like all other lines of insurance is covered by the McCarran-Ferguson Act. Individual state regulation has caused a wide divergence of regulatory practices, unauthorized practice of law rulings, and substantial variations in prices described in Volume II, Chapter XII. As shown in that Chapter, prices for title assurance and conveyancing services varied by over 100 percent in the eight sites analyzed in this study. The differences in cost of production did not appear to be the basis for the price differences.

The cost of title assurance and conveyancing services ranged from less than $300 in Denver to almost $600 in Los Angeles for a $60,000 house. If the Denver figure is taken as the level at which services could be produced, then some consumers in Los Angeles could save approximately $300 or 50 percent of the title assurance cost there. Savings elsewhere could range from $100 to $300, depending on the area and provider. For every one million homes sold annually, total consumer savings could equal $100 million or more if alternative suggestions led to the lowest rates possible. Achieving these levels of consumer savings, however, will have costs. Therefore, the advantages and disadvantages of each alternative, or combination of alternatives, is discussed.

The first three alternatives presented here embody two discrete forms of rate regulation which have been proposed for title insurance. One is total deregulation, known as "open competition." The other is rate regulation either by the Federal Government or by the states in a more consistent and reasonable manner. The fourth alternative is actually a method for implementing regulation. A Uniform Title Insurance Act could lead to consistent and better regulation.

Alternative 1: Establish Open Competition (Deregulation of Rates)

In 1977, the U.S. Justice Department studied the general issue of insurance regulation and concluded that the McCarran-Ferguson Act should be repealed and that insurance companies be allowed to price compete for business.[1] This latter concept has become known as "open competition." The Justice Department found that in many cases, insurance departments were insurance protecting industry participants rather than consumers. Prices were often higher than necessary to cover costs and losses adequately. The theory was that a freely operating marketplace would lower prices. However, this conclusion applied only to rate regulation. There was no suggestion that insurance companies should not be regulated for capital adequacy and reserve requirements.

In the same report, the Justice Department specifically recommended that two lines of insurance should not be put under open competition, title insurance and credit life and health insurance. The basis for this recommendation was the presence of intermediaries in the sale of these lines of insurance.

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[1] See Department of Justice, The Pricing and Marketing of Insurance (January, 1977).

Price competition is not likely to occur because competition is to gain referrers rather than consumers.[1]

Several states have moved to adopt open competition laws and the National Association of Insurance Commissioners (NAIC) is considering a model open competition statute at the present time. The NAIC has, however, set up a task force to determine whether title insurance should be included in the general open competition law or should be considered separately.

Advantages

The theory behind open competition is that in the absence of regulation, insurance companies will price compete. Prices will be driven down to the point where they cover costs (including losses) plus some reasonable rate of return on investment. For open competition to work, an industry must actively compete for the business of consumers. Providers must have reason to believe that they can increase their own market share or total industry business by lowering prices or offering better services.

Disadvantages

If the possibility of direct consumer sales of title insurance were realistic, open competition might be as valid a concept for title insurance as for other lines of insurance. Certainly with the trend toward branch operations noted in Chapter XII, the possibility exists for direct interaction with consumers. However, the nature of the buying patterns of title insurance does not seem to lend itself to direct consumer sales such as now exists in the auto and life insurance industries.[2] Consumers are not likely to become informed concerning title insurance because it is purchased so infrequently and seems relatively complex. The data in Chapter XII suggest that most consumers will continue to buy title insurance on the advice of referrers. Since these traditional referrers (real estate agents, lenders, and attorneys) are in a position to profit from their activities, they will continue to demand part of the excess profits generated by the title assurance process in the form of high commissions or through other forms of payment. This is reverse competition.

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[1] In the case of credit life and health insurance, the financial institution regulatory agencies have been very concerned about the possibility of institutions and lending personnel preventing competition. Banks cannot require the use of insurance companies that they own. In addition, the Federal Financial Institutions Examination Council has recommended that each of its constituent agencies (Fed. Reserve, FDIC, FHLBB, and NCUA) adopt a policy prohibiting individual employees, officers or owners of regulated institutions from receiving personal income from the sale of credit life or accident insurance (see The American Banker, January 17, 1980, p.4, "Bank Insurance Activities: A Brighter Outlook.").

[2] These lines of insurance were at one time marketed primarily through independent insurance agents. At that time, competition was through commissions to these agents rather than prices to the consumer.

Evaluation

While the ideal situation would be to eliminate or prohibit reverse competition and force the title insurance industry to compete directly in terms of price and quality, the likelihood of changing the basic nature of the markets seems small. Very few providers that we interviewed believed that direct appeals via advertising would help their business. This opinion seems to be consistent with other sources in the present study. Despite the information made available to consumers in the special information booklet, little shopping resulted for title insurance providers.[1]

In a situation where referrers--or intermediaries--channel the majority of buying decisions, open competition cannot reasonably be expected to lower prices unless the referrers themselves use the sale of title insurance as a marketing tool. Some authors have suggested that this is a possibility for real estate agents.[2] The theoretical argument for this case is that real estate agents are highly competitive for listings although they cooperate with other agents on sales. The pressure from fee-splitting discourages competition through lowering brokerage rates. These market imperfections may not preclude brokers from using title insurance rates as a price competitive tool. There is little or no evidence, however, of this occurring. The usual fear is that real estate agents will internalize the profit they receive either through kickbacks and referral fees or owning controlled businesses.[3]

In conclusion, our study shows that reverse competition is the dominant economic characteristic of the title insurance industry. To the extent that this is true, open competition in and of itself may not lead to a reduction in title insurance prices.

If open competition is not likely to lead to a reduction of high title assurance service charges, regulation of these charges at a reasonable level on a consistent basis might be a more productive alternative. This regulation could take place either at the federal or state level.

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[1] Only 13 to 17 percent of the home buyers interviewed by PMM&Co. spoke with more than one title insurance provider.

[2] Bruce Owen, "Licensing of Real Estate Brokers as Underwriter Title Agents", May 1976 (Studies in Industry Economics No. 64, Department of Economics, Stanford University). A report to the State of California, Department of Insurance.

[3] See discussion of the Coldwell Banker-Guardian title case in Chapter XII of Volume II.

Alternative 2: Initiate Federal Regulation of Title Assurance Charges

The McCarran-Ferguson Act prohibits federal regulation of the insurance industry. The concept of a repeal of McCarran-Ferguson (or exemption for a particular line of insurance) is usually applied within the context of open competition. The industries would be deregulated but subject to the federal antitrust laws. However, MccCarran-Ferguson exemption also opens the possibility for federal regulation of rates, although for most lines of insurance, federal regulation is not usually considered an option.

When HUD attempted to regulate settlement service rates in accordance with the Emergency Home Finance Act of 1970, there was a great deal of criticism of the efforts. However, at that time, no attempt was made to justify rates. Instead, HUD used the average rates charged in each area as a benchmark for reasonable fees. As this study has shown, such a procedure would insure the continuance of high title assurance and conveyance prices in some areas.

Nevertheless, the possibility of federal regulation of settlement services, including title assurance, continues. HUD has the power to set acceptable rates on homes financed with FHA or VA mortgages, although that power has never been used.

Advantages

The advantage of federal regulation lies mainly in the possibility of bringing about uniformity at the lowest possible price to the consumer consistent with reasonable production cost. A federal plan avoids the necessity of restructuring systems on a state-by-state basis and, thus, has the potential of faster implementation. A federal agency would also have access to more information and might be less swayed by special interest groups than some state insurance commissions.

If title insurance were exempted from McCarran-Ferguson, the industry would be subject to federal antitrust laws. Thus, there is the possibility that even without rate regulation, the threat of prosecution for price collusion might lead to a restructuring of prices and greater competition.

Disadvantages

The disadvantage of a federal take-over of insurance regulation is that there is no regulatory body which has the authority to assume these responsibilities. Any federal insurance regulation would entail setting up at least a new section in an agency, probably HUD. State insurance commissions, on the other hand, are already in existence. Their personnel have built up an expertise in insurance regulation, although our interviews indicated a lack of specific understanding of title insurance in some commissions.[1]

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[1] A common attitude was that title insurance premiums represented such a small part of total expenditures on insurance in the state that it did not warrant much concern.

The disadvantage of allowing the threat of antitrust to work with no other price regulatory effort is that except in states where rating bureaus are allowed, there is no proof that active price collusion exists for all services provided. High price areas would likely continue to exist.

Evaluation

The cost of establishing a federal insurance regulatory body, even for title insurance, might outweigh the possible benefits to consumers. While the cost of administration would have to be calculated carefully, the regulatory and enforcement personnel which would be necessary for a national insurance regulatory body could be high. In addition, a consistent set of principles on which to set these rates would have to be developed and accepted, which is a lengthy process. The dislocation among the industry and the regulators that would occur in the startup period could be quite serious. We do not favor this alternative.

Alternative 3: Promote Uniformity of Rate Regulation

State rate regulation has varied by both method and results as was shown in Chapter XII. Any improvement in the way states regulate this portion of settlement needs to treat four general considerations:

- What services should be regulated?
- What form of pricing should be used?
- What cost data for the industry should be used?
- What industry profit measures should be used?

The services regulated under title insurance statutes vary among states. In many states, only the risk premiums, or actual cost of insurance, is regulated. This was the case in Maryland and Florida in our sample sites. Other states regulate the cost of title assurance, including title search and evaluation. Colorado uses this form of regulation. A third method is to include conveyancing services in an all-inclusive rate. Texas uses this total package concept, although escrow fees are charged separately.

The individual states should regulate an all inclusive rate which covers each of the title assurance and conveyancing services discussed in this report.

An all-inclusive rate approach appears to be the more attractive alternative for two reasons: first, it is simpler from the consumer's view point; rather than having four or five different charges in the 1100 series of the HUD-1, the consumer would have only one price for all services. Second, in the majority of cases, the provider of title services also performs conveyancing services. To regulate fees for only a limited number of services allows providers to charge high fees for unregulated services.[1] The fact that attorneys perform many of the functions does not mean that prices cannot be regulated by insurance commissions. For example, in Colorado the service of title assurance, including title search and evaluation, is regulated no matter who provides the service.

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[1] The high charges in Texas for document preparation are a good example of the results when even one service is left unregulated.

Another issue in setting title insurance prices is the question of having a fixed price rather than a schedule of fees (for consumers) based on a house sales price.[1] As explained in Chapter XII, neither title insurance losses nor search costs are related to a substantial degree to sales price. Thus, the present procedure of basing rates on house price is artificial and not based on economic consideration. A change in the rate structure would have to be agreed on in conjunction with other changes.

The Form-9 developed by the NAIC is completed by each title insurance company for all operations aggregated nationally. These forms are filed with insurance commissions in states in which each company has operations. Much of the information concerns reserves, capital, and investments that affect the financial stability of the company. Most state insurance commissions receive little information on operating costs within their state.

If individual states are to effectively regulate prices, they must collect data on industry costs within their state. National cost information tends to present data which are totaled from different methods of conducting business. For example, in some states title plans are owned by the insurance companies and their personnel perform searches and provide conveyancing services. In other areas, title insurance attorney-agents perform all of the preliminary work. The title insurance company has no costs, and the agent passes through a portion of the risk premium to the insurer. National data combines the title insurance company cost and income from these very different situations, even though the totals may be meaningless in explaining the company's operations.

Consequently, state insurance commissions need to develop their own data in order to regulate fair and reasonable rates. Since these data are not provided at the present time, obtaining, processing, and analyzing such information would represent a new regulatory effort with commensurate compliance costs. However, the type of data necessary to regulate rates is not presently being provided at the national level either, since the Form-9 is primarily concerned with balance sheet items. New data collection efforts would be necessary, therefore, whether rates are set nationally or at the state level. In any case, agreement on the structure and definition of appropriate cost data would have to be addressed nationally, to realize substantial results from more focused state regulation.

Under any regulatory approach rates must be set so that there is a reasonable profit to the title insurance underwriters. Determining how these profits should be calculated is the most difficult part of regulating insurance rates. Traditionally insurance company profits are based on a percentage of premiums.[1] A figure of 5 percent of the premium amount is used by many state insurance departments.

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[1] Alternatively, three or four rates (over large ranges of house prices) might be appropriate. Rates would then increase with house price but only moderately and at discrete intervals.

The title insurance industry has taken the stand that the traditional method of profit allowance is unrelated to the way profitability is calculated in the real world.[2] They believe that profits should be allowed as a percentage return on total capital. Another method of calculating profitability is as a precentage of equity. This method provides information on the return to stockholders as opposed to all liability classes including reserves in the insurance industry.

General concensus on which form of profit measurement should be used has not been reached. Investment analysts have traditionally used ratios such as return on total capital or return on equity to compare different companies. The relationship of these measurements to rate setting in an industry where companies often have very different operating returns is not clear. Usually the rate of return is used in regulating public utilities, which operate as monopolies. In that case, there is no need to average a number of different companies.

Clearly, more work needs to be done in this area. However, it can safely be concluded that the goal is to determine a reasonable profit for a reasonably efficient firm. Less efficient firms may not be able to continue operating at that level and will have to drop out of the title insurance business. More efficient firms would be able to make higher profits. But the reasonable test should refer to a hypothetical, well-run firm, not to an average of existing data which may include many of the structural inefficiencies discussed in this report.

The profit being discussed here refers to insurance underwriter company profits. Presumably the excess profits discussed in Chapter XII, (which are often distributed to agents in the form of high commissions or profits to controlled business) would probably decline. For example, if the total price were regulated and set at levels comparable to those we observed in Denver, attorney-agents could not both collect for services performed and receive a referral commission, unless the insurance company desired to pay the commission from their own reasonable profits.

Advantages

The major advantage of state, rather than federal, regulation is that the states retain the final regulatory control so that situations unique to each state can be accommodated. While our findings indicated that conditions and industry costs do not vary significantly among states, it would be possible to account for any existing variations.[1] At the same time, prices for title assurance can be expected to become more uniform if the rate setting process is standardized in different states.

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[1] Irving H. Plotkin, On the Theory and Practice of Rate Review and Profit Measurement in Title Insurance (Cambridge, Mass: Arthur D. Little, Inc.), 1978.

[2] Ibid.

The next alternative to be discussed in this section is a Uniform Title Insurance Regulatory Act. Rate determination could be the major component of such an act if that were the preferred regulatory alternative. Federal encouragement of state regulation could overcome the reluctance of state insurance commissions to effectively regulate title insurance. State insurance commissions have an expertise which could easily be applied to title assurance services under a uniform act if they were convinced of the need.

Disadvantages

The major disadvantage of state regulation is that it is dependent on the various states to act. This procedure can take years, especially with an area such as title insurance which is not an important concern in most areas. There is no guarantee that all the individual state insurance commissions will make the necessary changes or develop uniform standards for evaluating prices and practices in the industry. Federal government encouragement of standardized regulatory practices would be essential.

Evaluation

State regulation of the title assurance and conveyancing industries under a uniform code is probably the most effective and efficient means of bringing about reasonable prices for these services. Increasing price competition in these industries does not seem feasible. While federal regulation would lead to uniform pricing across states, it might be costly and inefficient. Therefore, consistent state regulation seems to be the best alternative.

Alternative 4: Legislate a Uniform Title Insurance Regulatory Act

All of the alternatives suggested in this section have been proposed over a period of time as solutions to particular previously identified problems with the provision of title assurance and conveyancing services. Most of these recommendations would require action by the various state insurance commissions. Because of the numerous areas of regulation, an alternative that has been proposed and merits consideration is the enactment of a Uniform Title Insurance Regulatory Act to "standardize" the regulatory practices of the states. Such an Act could cover any or all of the areas discussed in this section and could lead to consistent and, hopefully, better regulation of the industry, for the benefit of both consumers and the share holders of insurance underwriting firms.

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[1] See Chapter XII of Volume II. Our findings were that neither title search costs nor losses vary among localities, especially urban areas where title plants are common.

Clearly, one of the areas of inconsistency among states is the regulation of rates. There are two possible ways that a model act could address this problem. One is that the act would set forth a given rate structure. This process would avoid state collection of data and would ensure that rates were based on a consistent data base. Greater uniformity could then be expected since our study indicated that costs of operation do not vary by state. The second method would be to provide a mechanism for setting rates. This plan would be detailed in exactly what considerations should go into price-setting. Presumably if losses and costs do not vary between states, the mechanism would lead to similar price structures. At the same time, if there were any legitimate cost differentials, the state could adjust the rates accordingly.

The second method would address issues discussed under the state rate regulation:

- services to be regulated;
- form of pricing;
- cost data; and
- industry profitability measures.

Exact determination in all of these areas would have to be defined in the proposed law.

Other areas of such a statute, which will be discussed shortly, would cover tied relationships and product inefficiencies. Further issues could be addressed if they were believed to affect either pricing or the provision of services in this industry.

A model act could be developed in two ways. One is for the Federal Government to develop the act with the participation of the industries, and encourage the states to adopt it. A second possibility is for the Federal Government to encourage and help the NAIC to develop an act and have its members encourage their respective states to adopt it. Either way, Federal Government encouragement and support would be needed.

The first alternative would allow the Federal Government to develop regulations that they believed were the most suitable for the title assurance industry without actually entering the area of insurance regulation.

Advantages

The advantage of a uniform title insurance regulatory act is that a well balanced and comprehensive regulatory approach could be offered to the individual states. The state insurance department staffs would be spared the cost and time of restructuring their present regulatory activities. Further, they would be presented with information on the industry from outside sources as a stable, understandable, and presumably unbiased basis.

A further advantage is that the Federal Government could be involved with developing consistent regulatory plans without having to implement them. The Federal Government has the advantage of being able to view the industry as it operates in different states and areas. The broad picture allows the development of consistent policy adaptable to specific situations, and is more likely to produce a balancing of interests between consumers and the underwriters.

Disadvantages

Under a uniform title insurance regulatory act the Federal Government could encourage but could not enforce the state-by-state legislation to comply with a uniform act. Individual states would have to enact matching legislation and enforce it. This may never occur or may occur in some states but not in others.

Evaluation

Despite the possibility that a uniform act would probably not be adopted in all states, it would appear that the most feasible method by which the Federal Government can attempt to encourage consistency and uniformity nationwide is the enactment of a uniform guideline legislation.

Since many state insurance commissions are not knowledgeable concerning title insurance, they have often minimized their regulatory effort in this area. However, a uniform act would provide them with the information they need and could make proposed regulation less difficult. We believe this plan has the best possibility of success.

TIED RELATIONSHIPS

If the prices of title assurance were set at a level commensurate with cost, then tied relationships would not raise the cost to consumers. However, where prices are not regulated, or are set at excessive levels, high prices may both cause and be a result of the type of tied relationships between brokers, lenders, attorneys, and title insurance companies.[1] Further, the perception that individuals benefit from the sale of ancillary services because of their position in the real estate transfer process has precipitated much of the concern about the provision of settlement services. Therefore, the regulation of these relationships has been proposed in the past and will be addressed as a separate issue.

Alternative 5: Prohibition of Controlled Business

Under this alternative, referrers (including real estate brokers, lenders, and attorneys) would be prohibited from referring clients to a title company or title insurance company in which they have an ownership interest and from which they receive profits. The rationale is that profits from controlled business have replaced kickbacks and direct payments as rewards for a referral position.

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[1] The cause and effect relationship of tied business and prices was discussed in Chapter XII of Volume II.

This type of prohibition would be aimed at the following situations:

- real estate broker-owned title companies;
- S&L-owned title companies or agencies (through their service corporations);
- bar-related title insurance companies which distribute profits according to the amount of title insurance business referred to the insurance company; and
- attorney-owned title companies other than bar-related funds.

The American Land Title Association has been active in criticizing what they have called "controlled business.[2] While they are against all forms of referrer-owned title companies, the real estate broker firms appear to be the most often criticized. Real estate brokers and agents have widespread contacts, and often a few of them can control a major portion of the market in a given geographic area.

However, a widespread ruling that prohibits controlled business would affect referrer-owned title companies. The lending institutions regulatory agencies, whose job it is to decide what their members may own as sudsidiaries have not been concerned about the effect on competition in the title insurance industry. The many savings and loan associations have set up title companies through their service corporations, which is explicitly sanctioned by the Federal Home Loan Bank Board and the Bank Holding Company Act.

It is not clear whether controlled business is covered by Section 8 of RESPA. If it is a legal violation of RESPA, then a regulation to that effect could prohibit the practice. Otherwise, new legislation is probably necessary to clarify and resolve the current inconsistent definition of "controlled businesses".

Advantages

Proponents of this measure feel it would deny the "final" avenue for benefitting from their referral position, since kickbacks and referral fees are already prohibited under RESPA. However, the more likely result is that referrers would find some other means for benefitting from their position. The

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[2] See Chapter XII Volume II.

The economic incentives are extremely strong, given the lack of knowledge of consumers, high prices, and the ability of referrers to control business placement.

There is also the advantage that if controlled business is covered by Section 8 of RESPA, HUD can develop regulations prohibiting the situtations without waiting for further legislation.

Disadvantages

This prohibition would do nothing to alleviate the problem of lenders requiring the use of specific attorneys. Nor would it stop the large commissions paid to attorney-agents, underwritten title companies and other agents by the title insurance companies. The prohibition is strictly limited to ownership interests and does not include commissions.

Evaluation

There is no reason to believe that if controlled business is prohibited prices will fall. As explained in Chapter XII, no proof exists that controlled business has raised prices to date. Since title assurance services are not price competitive in most areas, the prohibition against controlled business should not be expected to have an effect on price levels.

Alternative 6: Require Referral List

One alternative to prohibiting controlled business is to require referrers to supply the names and price schedules of several, perhaps five providers of the different types of settlement services.

While referrers would not be prohibited from recommending their own controlled business, a list which included prices of other providers might lead to some price competition. However, the advertised prices would have to be all inclusive or explicitly circumscribed. If the list covered only some items and not others, the price of the unlisted items could be used to offset lost income on the listed items.

This particular alternative could be applied not only to recommendations to title companies, but also to attorneys. In Chapter XII of Volume II, the practice of lenders requiring the use of specific attorneys to review documents was discussed at length. The possibility that such requirements raise the cost of settlement to consumers was also mentioned. One alternative is for lenders to supply a list of law firms whose work they will accept and the prices those firms charge. In most areas, a list of at least five firms would not be unreasonable. Such a list should include the lender's associated service corporation, where applicable, along with disclosure of the business relationship. Note that lenders are entitled to the legal protection of a document review by a qualified and knowledgeable attorney. This alternative gives the borrower access to a pricing decision, which should not put the lender at a disadvantage.

Advantages

The concept of a multi-provider list either of title companies or attorneys could be applied to real estate brokers, or lenders. If prices were regulated, the list would not lead to increased price competition. However, it would prevent the perception that referrers benefit unreasonably from their positions in the process.

Since many home mortgage lenders are federally chartered, prohibitions against required attorneys would not be technically difficult to implement. This is especially true in the case of federally-chartered Savings and Loan Associations. The Federal Home Loan Bank Board has rules prohibiting certain relationships.[1] Thus new regulations would be simple to enact, although they might be unpopular with some industry groups. Mortgage bankers, with some exceptions, are not regulated because they are not depository institutions. However, the majority of mortgage bankers arrange for FHA/VA loans. HUD has the power to regulate settlement practices on these loans.

Disadvantage

There would be an initial cost to such a plan. Lenders or real estate agents would be required to gather market information from the required number of providers. In all probability, the providers would be competing to be placed on the list and the referrer would have to decide which names to accept.

Evaluation

If prices are unregulated, provider lists would probably be the best method of lowering attorneys charges and title assurance prices. If consumers were aware of different price levels, they would undoubtedly prefer the lowest charges possible.

Lenders should probably be prohibited from requiring consumers to pay for the services of a specific attorney. Such situations can weaken any incentive for price competition and may put the consumer in a position of having to pay more for title assurance and other conveyancing services than might be necessary.

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[1] For example, member associations can no longer require the use of a particular hazard insurance agency. Nor can they require the use of a particular title insurance company.

Alternative 7: Enforce RESPA; Remove Ambiguities in Regulations and Interpretive Rulings

While the Federal Government does not have the power to regulate title assurance prices and activities, it does have the mandate under RESPA to prohibit kickbacks and payments for referrals. Violations of Section 8 of RESPA can be prosecuted by the U.S. Justice Department. As mentioned in Volume II, Chapter XII, only one prosecution has ever occurred under RESPA. That case involved public employees in Chicago who were working in the Torren Registration Office.

Our interviews with all of the providers indicated that the lack of enforcement of RESPA·Section 8 is a well-known fact among individuals in the settlement service industries. A decision by the Justice Department to enforce the Act, even on a selective basis, could diminish activity of this kind. Our interviews indicated that kickbacks, payments for referrals, and gifts or favors continue at least to some extent. While it is impossible to know exactly how widespread the practice is, its continued existence indicates awareness that the Executive Branch has shown little interest in enforcement.

Such enforcement should only be undertaken, however, after resolution of current ambiguities in the regulations and rulings, especially the most recent one on controlled businesses.

Advantages

Increased enforcement efforts would not require a new agency; increases in Justice Department personnel time would be the only direct cost. Congress has previously expressed its belief that such practices are not consistent with the public interest. Enforcement would also indicate that the Federal Government is genuinely concerned with practices in settlement service industries.

Disadvantages

The theory behind the passage of Section 8 was that referral fees contribute to high consumer prices. The belief was that prohibiting these fees would cause consumer prices to fall. However, even if no kickbacks or referral fees were paid, consumer charges would fall only if industry savings were passed on to consumers. A more likely result is that the currently prohibited payments would find other outlets not covered by RESPA. Other possibilities are that the title assurance providers might internalize the savings in profits.

Evaluation

Additional enforcement activity could be relatively small and would not involve great cost or major reconsiderations in settlement service industries. However, a small additional resource allocation would cause providers who engage in illicit activities to be put on notice that the intent of Congress will be addressed. However, no useful purpose will be served by more vigorous enforcement until regulation or rules are stripped of ambiguities. Removal of these ambiguities may require congressional action.

INEFFICIENT PRODUCT CHARACTERISTICS

Two additional proposals involve changes in the basic methods of provision of title insurance. One alternative is product alterations including: (1) the use of one title insurance policy to cover both the lender and the owner; and (2) a substantial discount for home buyers who purchase a home in a subdivision or a condominium directly from a builder or developer. The other is provision alternatives, i.e., seller-pay of title assurance services. The single title insurance policy and subdivision discount will be discussed as one alternative because the advantages and disadvantages are similar. Both alternatives would make only marginal changes in the product.

Alternative 9: Implement Product Alterations

Alternative 9a: Single Title Insurance Policy

The use of two separate policies for Title Insurance creates an unnecessary confusion as to what contingencies are covered by the policy. Lender policies are not always identical to owner policies. Often they cover different contingencies. However, any payments under the lender policy will only occur in amounts in excess of the equity in the house. In other words, the value of the mortgage must be threatened in order for the lender's policy to become operative.

A policy for title insurance written such that the owner and lender are both covered under one policy for the same contingencies would simplify the nature of title insurance and help clarify the liabilities of the insurer. The result would be a title insurance policy similar to a fire insurance policy under which the lender and owner both receive proportionate payments if the contingency occurs.

Alternative 9b: Subdivision and Condominium Discount

When a builder or developer aquires a piece of land, the title to the property is searched until that point in time. After the units (either homes or condominiums) are completed, each individual buyer purchases a policy to his individual unit. The only discount available to the final purchaser is a reissue rate. (Usually he must ask for that rate).

Since the title to the property was searched only a short time before, equity seems to indicate that the individual buyer should get a substantial discount. At least one state has enacted such a discount provision. In Wyoming, state regulation requires that buyers of homes in subdivisions or condominiums receive 40 percent off the regular regulated rate for title insurance.

It should be noted that the new title policy does involve some additional work. The title insurance company must check for mechanics' liens and taxes due. The former is a real problem with new construction, where subcontractors frequently are not paid for work performed. Thus, searches must be made after construction is completed. However, costs are reduced because there is no need for the search to cover the period of time before the land was purchased.

Advantages

Both of these recommendations could be enacted without a revision of the title insurance regulatory procedures. They could be formulated into policy either by the state insurance commissions or by the title under writers.

The changes would be marginal, but they would simplify the process and make the title insurance product easier for consumers to understand.

The introduction of a single policy would eliminate the present practice of lenders' coverage differing from owners. Exclusions would be the same for all parties; processing would be simpler as well.

The subdivision discount would save substantial charges for some home buyers and would eliminate the profitable situation of a single provider, conducting the title search on a single piece of property and then charging regular fees for the subdivided parcels of the same piece of property.

Disadvantages

The subdivision provision would lead to a reduction in charges for some housing units. However, the vast majority of homes sold every year are existing, not new, units. They would not be affected by the provision for savings on subdivisions. Thus, it is not clear what the savings in the aggregate from the provision would be.

The single policy provision may not affect total charges to consumers if the final policy were priced at the same level as a simultaneous issue policy.

Evaluation

Both provisions could be enacted with little cost and possible benefit to some consumers, with little if any adverse impact on the underwriters.

Alternative 10: Institute Seller-Pay

Another suggested alternative to the present system of regulation is to require the seller to pay for title insurance. Actually, the seller already pays for the search and owner's title insurance in most states west of the Appalachian Mountains.

Advantages

In states where the buyer pays for title assurance, funds necessary to purchase a home would be reduced. If a goal of RESPA were to increase home ownership, then seller-pay of title insurance charges in all areas might have an advantage, although overall settlement charges would not be affected.

Disadvantages

The result of this suggestion would not necessarily be a reduction in total settlement costs. There is no reason to believe that sellers would be more informed or able to negotiate for terms and prices better than buyers. Thus, total charges for title assurance are not likely to be affected by a seller-pay plan in the absence of any other charges.

Evaluation

A likely result of seller-pay would be an expansion of the role of real estate brokers in the choice of title insurance providers. Real estate agents are hired to represent the seller. Thus, they might have an even more receptive client base for referrals for title insurance, than among home buyers. The expansion of the role of the real estate broker in the choice of title assurance providers would probably lead to more referral payments and controlled business. The effect on the total charges for title assurance services would probably not be reduced.

SUMMARY

The issues addressed in this section have been attributed as the principal reasons for title assurance and conveyancing services being characterized as evidencing neither workable competition nor efficiency.

A wide range of proposed alternatives affecting title assurance and conveyancing providers has been considered here. The alternatives described cover methods of price regulation, tied relationships, and product alterations. Most of the alternatives suggested in this section would require state-by-state implementation. There is less persuasive support for federal regulation of title insurance; consequently the state insurance departments would have to take on changes in their present regulatory processes.

The alternatives discussed would be more likely to affect providers at the local level than at the national level because they are designed to reduce the total cost of title assurance and conveyancing services other than underwriting. Attorneys and real estate brokers would be more likely to be affected than the title insurance underwriters. However, a reduction in total revenues could affect providers at all levels, both national and local. If the title insurance industry is characterized by noncompetitiveness, lower revenues could lead to a decrease in the number of viable firms. However, the firms which remain would presumably be more economically efficient.

IV. THE LENDER-PAY ALTERNATIVE

This volume has focused on alternatives which would either modify RESPA, but retain its basic objectives, or modify specific settlement service industry practices. Another system-wide alternative was proposed to Congress during its deliberation prior to the passage of RESPA. The concept was that lenders should arrange and pay for the cost of settlement services. This idea has become known as the "lender-pay" concept. Following a discussion of the background and rationale behind lender-pay, this chapter will discuss:

- the criteria for recommendation of a lender-pay proposal;
- the development of a "best" lender-pay system;
- the likelihood of a reduction of cost under a lender-pay plan;
- the likely efects of a lender-pay plan on settlement service industries; and
- an evaluation of implementation options for lender-pay.

BACKGROUND OF THE LENDER-PAY CONCEPT

The basic concept of lender-pay is that lenders would offer a package of settlement services to the home buyer. The lender would decide what services were necessary and would either provide them himself or purchase them from providers. The borrower would have only one decision to make, namely which lender to use.

Many of the settlement charges analyzed in this study result from mortgage lenders' attempts to minimize their own risk. Mortgagee title insurance protects the lender against future claims by persons asserting a legal interest in or claim against the property secured by the mortgage. Mortgage insurance protects the lender against loss by default of mortgagors who have very little equity in their houses. The lender's attorney ensures that the documents and transfers follow the legal requirements of the area, and he may also do the title work and conduct settlement. In addition, the lender usually requires a credit check, an appraisal of the property, and a survey. Since all of these services are performed for the lender's protection, payment for them by the lender would appear to be reasonable.

A further rationale for the lender-pay concept depends on the relative power of lenders and consumers in the marketplace for securing settlement services. Since most consumers purchase settlement services infrequently and are not informed about the prices, products, and providers, it is difficult for them to shop intelligently. Lenders, on the other hand, are in the mortgage business. If they purchase settlement services for all of their loans, they would have an incentive to obtain the best quality at the lowest price.

Unlike most borrowers, lenders would be informed and knowledgeable about settlement services. Presumably, they could negotiate lower prices for the services they purchased using their market power. In addition, in an effort to keep cost at the lowest possible level, lenders might supply some services themselves rather than hiring outside firms. Another form of cost savings might result if lenders, having to pay the costs, decided that some of the services now required were unnecessary.

An additional benefit would be that the provisions of RESPA as presently formulated would no longer be necessary. Since home buyers would no longer need to shop and pay for services, neither the special information booklet, the good faith estimates, nor the HUD-1 would be necessary. Further, Section 8 of RESPA which forbids kickbacks and referral fees, would no longer be necessary because lenders would presumably be able to lower prices and squeeze out the excess profit available for these payments. Also, controlled business would need to be permissible because one method by which lenders could reduce charges is to provide services themselves rather than purchase them from other providers.[1]

For all these reasons, the lender should be in a good position to provide (or arrange for) required settlement services at a reasonable cost. However, the lender may:

- not actively seek to provide required settlement services most efficiently; or
- arrange for the efficient provision of services but not pass on the savings to the home buyer.

Only if the lender is under considerable market pressure to provide the services efficiently and at a low price to the home buyer can he be expected to do so. The proponents of lender-pay argue that the market for lenders' services is the most competitive of the settlement service markets and that a price-competitive market would indeed force the lender to provide settlement services at a lower price than currently prevails in most markets.

Under lender-pay, the consumer will ultimately pay for the services in one of several ways, which will be discussed in this chapter. However, lenders would be selling a package of settlement services directly to the consumer with the loan.

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[1] Controlled business is not covered by RESPA Section 8 at the present time. However, HUD has issued an interpretive ruling which states that controlled business may be a violation of Section 8. This ruling is inconsistent with the lender-pay concept.

History of Lender-Pay

The lender-pay plan was first proposed in an article written by Professor Dale Whitman.[1] The essential elements of the plan described in that article have defined lender-pay for discussion. Those essential elements are:

- Mortgage lenders would be required by federal law to pay all costs, both those atributable to the transfer of the property and those related to financing.
- Mortgage lenders would be required to provide home buyers with title and settlement services equivalent in quality to those services obtained by lenders for their own benefit, and in all events meeting federally prescribed standards.
- Mortgage lenders would not be permitted to charge home buyers or sellers any fees, discounts, or other charges except simple interest. All loans would be required by law to be made "at par" from the borrower's viewpoint; the full amount of the loan would be disbursed to the borrower to be applied toward the purchase of the property.[1]

The Whitman plan not only requires lenders to pay all settlement costs but would disallow any up-front payment at the time of closing. The lender could recoup the costs only in the form of a higher interest rate. In addition, points and origination fees would not be allowed. Thus, the traditional method by which lenders have increased their yield on loans with low interest rates, would no longer be permissible. This method is used by lenders to enable them to participate in FHA and VA programs (and in states which have usury ceilings below the prevailing market rate).

Before RESPA was passed, Senator William Proxmire held hearings on a bill that would have proposed federal legislation to require mortgage lenders to pay all settlement costs attributable to the transfer of title and the financing of single family homes.[2] While Senator Proxmire's bill was never passed, one of the requirements of Section 14 of RESPA was that lender-pay be studied as a possible alternative to the present system.

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[1] Dale Whitman, "Home Transfer Costs: An Economic and Legal Analysis," 62 Georgetown Law Journal (1974) pp. 1311-1360.

[2] Op. cit., Whitman p. 1345.

[3] Senator Wm. Proxmire, Chairman of the Senate Committee on Banking, Houses, and Urban Affairs, introduced the bill to enact the legisltaion described. See S.3232, 93rd Cong., 22 Sess. (1974). Also see 120 Congressional Record 80 90 (1974) (introductory comments by Sen. Proxmire).

Recent Literature

The Proxmire bill generated some controversy about lender-pay but because the bill was never enacted, little literature was written on it. However, with the inclusion of lender-pay in RESPA Section 14, it assumed the potential of becoming an issue in the future. As a result, two lengthy articles on the subject appeared, one by Diana Stoppello[1] and another by Arthur Warner.[2] Both articles came to the conclusion that lender-pay would not result in any net benefits to the consumer.

Most of the objections to lender-pay mentioned in these articles will be discussed throughout this chapter within the context of specific lender-pay plans. However, because the two articles assume different primary objectives for federal intervention in the settlement services market, the methodology and conclusions of the two pieces are very different. Stoppello considers the basic problem to be the noncompetitiveness of settlement service industries and the resulting high cost of the individual services. She recommends that the broker distribute good faith estimates, including at least three names of providers for each service and a price list. She believes that this will cause home buyers to shop, increase the competitiveness in settlement service markets, and eventually cause prices to fall.

For Warner and Ingram, on the other hand, the primary desired outcome is the reduction of the up-front cost of home ownership so that lower income people without savings will be eligible to purchase a home. The idea that up-front costs are a barrier to home ownership has been the basic motivating factor behind much of the housing legislation of the last 30 years.[3] Certainly this is a major objective of lender-pay, according to Whitman. He says, "The cost of transferring residential property may have a major impact on two important national goals, widespread home ownership and increased housing production, since such costs limit the number of prospective home buyers."[4]

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[1] Diana Stoppello, "Federal Regulation of Home Mortgage Settlement Costs: RESPA and its Alternatives" 63 Minnesota Law Review (March 1979).

[2] Arthur E. Warner and F. Jerry Ingram "The Lender-Pay Proposal: An Analysis of the Potential Impact on Home Buyers and Mortgage Lenders," a paper presented at the Annual Meeting of the American Real Estate and Urban Economics Association, Atlanta, December 1979. (Preliminary draft.) (This study was funded by the American Land Title Association which is opposed to lender-pay.)

[3] The FHA/VA programs are explicitly aimed at making home ownership easier for people with little in the way of available funds. The establishment of a federally chartered Savings and Loan Association system had this same objective.

[4] Op. cit., Whitman, pp 1312-1313.

While the two objectives are certainly not mutually exclusive, neither are they necessarily synonymous. Hypothetically, lender-pay could increase the real cost of settlement services while decreasing up-front costs. This could happen under the Whitman plan, if the interest rate were increased by more than the amortized amount necessary to cover settlement costs, i.e., if lenders were making a profit.

While decreased up-front costs and increased home ownership have been major goals of the U.S. government, they do not appear to be an explicit goal of RESPA. RESPA was enacted because of perceived abuses and inefficiencies in some settlement service industries. According to the Act, the purpose was to "effect certain changes in the settlement process for residential real estate that will result:

- in more effective advance disclosure to home buyers and sellers of settlement costs;
- in the elimination of kickbacks or referral fees that tend to increase unnecessarily the costs of certain settlement services;
- in a reduction in the amounts home buyers are required to place in escrow accounts established to insure the payment of real estate taxes and insurance; and
- in significant reform and modernization of local recordkeeping of land title information."[1]

CRITERIA FOR EVALUATION OF LENDER-PAY

The principal consideration that we have used in this study for evaluating the lender-pay concept is its effect on the cost of settlement services.

To lower total settlement costs, several conditions would need to occur. First, charges to lenders would have to be lower than those to individual home buyers. Second, the difference would have to be passed on to borrowers.

As mentioned previously, total charges could possibly be lowered in several ways:

- Lenders could negotiate for lower prices or quantity discounts from providers. Presumably because of knowledge and large scale purchases they would be in a better position to negotiate than most buyers.

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[1] The Real Estate Settlement Procedures Act of 1974, as amended in 1975, Section 2, Findings and Purpose.

- Lenders could perform some services with their own personnel or through firms which they owned rather than purchasing these services from other providers.

- Lenders could reduce the number and kind of services which they require.

Whitman assumes that savings will occur, and that lenders will pass these savings on to borrowers. He claims that lenders are competitive for mortgages and will attempt to attract borrowers by lowering their rates. Stoppello feels that most lenders are much more competitive in seeking deposits than mortgage loans and are unlikely to pass along savings for the forseeable future.[1]

The likelihood of any of these situations occurring will be discussed within the context of specific services in several sections. While all of these possibilities exist, they are more likely to occur with some specific services than with others.

One way to look at the likelihood of any possible savings being passed on to borrowers is to look at cases where lenders arrange for some services at the present time. However, this situation does not allow for the concept of packaging, which supposedly would make it easier for borrowers to compare lenders because only one price and uniform services would be involved. Nevertheless, some present practices might provide insight into the behavior of lenders.

Since lender-pay would involve a major restructuring of the process of settlement and the provision of related services, the alternative should not be recommended unless an analysis can demonstrate that there is a reasonable expectation of lower settlement prices.

"BEST" LENDER-PAY PROPOSAL

While the Whitman plan was the first complete statement of the development of lender-pay, there are possible variations of the idea. The basic concept is that lenders arrange and pay for settlement services and then sell a package of services to borrowers. Proposed variations of lender-pay concern the method by which borrowers pay for the settlement services. Whitman suggests that payment be made by increasing the interest rate. However, there are two other methods that merit consideration. One is a lump sum up-front payment by the borrower. The other is an increase in the amount of the mortgage loan, or as a second loan to cover the settlement charges.

Additional considerations are:

- the services that should be included;

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[1] One indication of this type of rivalry is that lending institutions advertise more often for deposits than for mortgagors.

- whether the package should be mandatory (to the borrower) or voluntary; and

- whether lenders' participation should be voluntary or mandatory.

This section will analyze these issues and discuss the advantages and disadvantages of each of the different pass-through methods.

Items for Inclusion

The obvious items for inclusion in a lender-pay plan are all of the financing charges plus charges for those services which the lender requires and for which he could, theoretically, negotiate prices. Those items over which the lender has no control, and which he does not request and could not affect, should not be included. The reason for not including some items is that if a lender cannot affect the price, settlement costs cannot be lowered. These are the considerations by which a lender-pay plan will be evaluated.

Using these criteria, the following items would appear to be candidates for inclusion within lender-pay:

- Group 1:
  - Application fees;
  - Loan Origination fees;
  - Points;
  - Appraisal;
  - Credit Report;
  - Survey; and
  - Mortgage Insurance.
- Group 2:
  - Title Assurance Costs:
    - Mortgagor/Mortgagee Insurance;
    - Title Search and Evaluation; and
    - Abstracting.

- Conveyancing Services:
    - Attorney Fees (for conveyancing services);
    - Document Preparation Fees; and
    - Settlement and Escrow Costs.

As illustrated above, the items recommended for inclusion fall into two basic groups. Group 1 includes all of the lenders fees which commonly are charged in addition to the interest on the loan. Application fees, loan origination charges, and points are paid to the lender before the loan is made. They usually are part of any package which a lender is selling. Other items in Group 1 are commonly required by lenders for their own protection and are of little direct benefit to the borrower (except to make mortgage money available to the borrower). The appraisal and the credit report are required to determine whether the house value will cover the mortgage and whether the borrower has a good credit rating. The survey is not always required. However, because lenders often arrange for surveys and can certainly negotiate the cost, the survey is included in Group 1. Mortgage insurance is needed by the lender. He now arranges for the insurance and chooses the provider.

Group 2 includes title assurance and conveyancing services.[1] To some extent, these items are necessary whether the lender requests them or not. Every home buyer should know the status of the title to the proposed purchase. Similarly, conveyancing services such as actual settlement must be performed, whether it be by attorney, lender, title company, or broker. While these services benefit the borrower, they are also a protection to the lender. Often lenders require the use of specific attorneys, as has often been noted in this study.[2] In the other parts of this study, the effect of reverse competition on title assurance and conveyancing services has been discussed many times. Clearly lenders are more informed than home buyers regarding these services. Thus, they are in a position to purchase and negotiate these services with both attorneys and title insurance companies.

The items not included in the above list which are commonly paid at settlement are:

- brokerage fees;
- recording and transferring taxes;

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[1] All of these items are found in the 1100 series on the HUD-1 form.

[2] Attorney charges included here are for conveyancing services only (settlement, escrow, and document preparation). If a buyer decides to hire an attorney to negotiate or handle other matters in his behalf, those charges would not be included in a lender-pay plan.

- hazard insurance premiums; and
- escrow for property tax.

Brokerage fees are agreed to and paid by the seller. The lender could not affect these charges. Further, they are not related to the mortgage or the borrower. No one who has studied lender-pay has suggested that brokerage fees be included.

Recording and transfer taxes are set by the state and local government. In some localities, taxes can be as much as one and a half percent of the sales price of the house. Usually a custom develops in the area for either the seller, the buyer, or both to pay these taxes. While it may be customary for one party or the other to pay, it is a negotiable item in most cases. While the buyer may pay the taxes, the sum due should not be added into the lender-pay package. The lender cannot lower the taxes, thus this item would not lower settlement costs. Further, if lenders were required to pay taxes as part of a package, the buyer could be hurt in those areas where sellers presently pay all or part of the amount due unless the house price fell by the amount of taxes which the seller would no longer be paying.

Hazard insurance and property taxes may be considered as a cost of home ownership rather than home purchasing. They are payable every year, not once at the time of purchase. Therefore, they should not be included in a lender-pay plan.

Voluntary or Mandatory

Another issue is whether a lender-pay plan should be mandatory for either the lender, the borrower, or both. From the lender's perspective, lender-pay is voluntary now. There is no reason why a lender cannot package settlement services and be reimbursed. However, few if any lenders do. It appears that there are not adequate incentives for a lender to provide such services on his own; otherwise lenders would perceive an advantage in providing such services and would engage in them voluntarily. If a government-sponsored program were voluntary, there seems little reason to believe that many lenders would participate in the absence of those incentives. For many, the initial effort and cost of setting up the plan would act as a substantial barrier while the prospect of increasing loan activity and/or profits would be doubtful.

The only lenders who would be interested in packaging services under a voluntary plan would be those who believe they could improve their overall profitability and/or increase their market position. To create a competitive atmosphere in which lenders attempt to gain customers by offering the lowest price for a package of settlement services, lender-pay as presently defined would have to be mandatory. Every lender would be required to offer a package of settlement services, among which consumers can shop for the best price.

Should borrowers be required to accept the settlement service package offered by a lender in order to take out a mortgage loan? Clearly, such a mandatory provision would appeal to lenders if they were required to offer a lender-pay plan. They might be able to negotiate with suppliers more easily if they could guarantee a certain number of purchases. However, mandatory settlement packaging would work to the detriment of those few borrowers inclined to shop if they could find cheaper prices elsewhere.

The next section will analyze different methods of paying for settlement services through lender-pay. These include an up-front lump-sum payment and lending the amount of the settlement cost either in a separate loan or by increasing the amount of the mortgage. In either of these situations, a mortgagor may feel that he can package settlement services at less cost than if the services were provided by a lender. If so, he should not be forced to accept the more expensive package. Even under an interest-rate-only plan, the borrower may want to provide his own services.

Pass-Through Methods

Requiring lenders to arrange and pay for settlement services will not mean a "free lunch" for consumers, regardless of whether the payment is direct or hidden in the interest rate. While Whitman suggested only one method by which the lender could recover the expenditures for settlement services, the possible methods are:

- interest rate increase;
- up-front lump-sum payments; and
- loan increase.

This section discusses the advantages and disadvantages of each of these methods. The next section will discuss the likelihood that any lender-pay plan will actually lower settlement prices for consumers. The different methods will be discussed in detail because the payment approach is critical to the effectiveness of lender-pay in lowering costs.

Interest Rate Increase

The Whitman proposal of charging all costs through the interest rate has great appeal. Whitman estimates that the average cost of settlement services is approximately 1.5 to 2 percent of the loan amount. For the hypothetical

$60,000 house with a $50,000 mortgage, used as an example in other parts of this study, settlement costs would thus amount to $750 to $1,000.[1] Whitman also assumes that on a 30-year loan, with repayment in 12 years, the increase in the interest rate would be approximately one-fourth of one percent.

Advantages. There are several attractive aspects to the increased interest rate approach. The main appeal is the simplicity of having only one price. The consumer can shop among lenders and compare interest rates. There would not be the confusion, as there often is now, of comparing one lender who has a lower interest rate and higher up-front costs with another lender who has a high interest rate and lower up-front costs. While the RESPA booklet advises consumers to use the "one percent up-front equals 1/8 percent in the mortgage" rule, borrowers may have difficulty with these comparisons.[2] The interest rate method would reduce confusion and greatly simplify price comparisons.

A less important benefit to consumers is that their tax deductions due to home ownership might increase since all interest payments are tax deductible. Of course, these additional deductions would represent a loss of income to the Federal Government. (The Internal Revenue Service would have to allow the payments as interest on a loan for this to occur. If the monthly payment were considered expenditure for services, it would not be deductible). Settlement costs are now considered part of the base for purposes of calculating capital gains. Thus capital gains taxes, where applicable, could increase. However, since personal tax rates are higher than capital gains rates, there would be a net gain in tax savings in the majority of cases.

This method would also reduce the out-of-pocket charges paid at settlement and, therefore, could aid those home buyers for whom an up-front expenditure of between $500 and a $1,000 might make the difference in their ability to purchase a home. However, this benefit should not be overstated. The lender-paid items would probably not include transfer taxes, which in some localities amount to 1 to 2 percent of the purchase price. Nor would the package include escrows and amounts due for property taxes or hazard insurance.[3] Thus, the buyer could still need substantial funds above the amount necessary or a down payment. Further, lenders might require higher down payments since their investment in the case of lender-pay would be not only the amount of the loan but also the lender's funds expended for settlement costs.

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[1] This assumes the mortgage interest rate is the true market rate so that points are not required. It does not include broker's fees or the conventional mortgage insurance. Broker's fees are traditionally paid by the seller. Mortgage insurance would add $300 to $400 to this cost of closing.

[2] This rule of thumb is not exact since the mathematical relationship is not linear.

[3] Whitman suggests that attorney charges also not be included. Supposedly, these are the borrower's attorney fees not the lender's attorney fees.

Disadvantages. The disadvantages to the interest rate plan fall into two broad categories: (1) the possible disadvantages to the individual borrower, and (2) the problems for both primary lenders and investors in mortgages.

The most obvious disadvantages to the borrower is the possibly substantial increase in the monthly payment. An additional percent on the interest rate would amount to $9.26 per month on a $50,000 mortgage for 30 years at 10 percent. However, if lenders are not allowed to charge points, the increase in the interest rate could be much higher. In periods of tight money, lenders have traditionally used points to increase the yield on mortgagors. This is particularly true of FHA/VA insured mortgages which have interest rate ceilings. To adjust for current market yields that are in excess of those ceiling rates, lenders have additionally charged points to the seller, and up to 1 point to the buyer, to raise the yield.

Under an interest-rate-only proposal, no points could be charged to either buyers or sellers. Instead, the interest rate would be allowed to rise. In a hypothetical example, assume a lender needed to charge four points to equalize the yield on an FHA or VA mortgage with the current market rate. This would indicate that the market yield was approximately 60 to 70 basis points above the ceiling rate on the government-insured loan. Under lender-pay, the borrower would pay the additional one percent for the loan, plus one-quarter percent to cover the settlement fees. The total increase in the monthly payment on the $50,000 loan just described would be $45.30.

Since potential mortgagors are usually limited by lenders to a certain percentage of their income for housing costs, an increase in the monthly payment may be a barrier to potential home owners. Whether more potential home owners would be closed out under a lender-pay system than under the present system is impossible to evaluate definitively. However, because of today's higher interest rates, due primarily to inflation and to a restrictive monetary policy, many potential home buyers have already been closed out of the market. Further increases in the monthly payment would only exacerbate the problem.

An additional consideration is that most lending sources believe that the average life of most loans at the present time is six to eight years. Until recently, the average life was thought to be 12 years. If the lender's required yield is calculated on a expected life of less than the maturity of the mortgage, then those home buyers who hold their mortgages longer than the assumed holding period will pay more for settlement services than those who sell their homes and repay the mortgage in a shorter period of time. This situation however, could be solved with a prepayment penalty in early years[1]

There are several disadvantages of the interest rate increase to both lenders and investors which would need to be overcome by regulatory changes before the lending industry, as a group, could adapt to such a program. The policy of federally organized secondary markets not paying premiums would have to be altered. If a primary lender pays for settlement services and then sells the loan on the secondary market, that original lender would need to receive a "premium" on the par value of the mortgage to cover settlement expenditures. At the present time, neither organized secondary markets nor most other investors will pay premiums because there will be a loss if a loan is prepaid, as is often the case. Theoretically, a prepayment penalty could offset this loss. However, with more sophisticated investment vehicles such as mortgage-backed bonds, there may be difficulty in matching prepayment penalties and mortgages.

In any case, both the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association would need to adapt their rules and procedures for lender-pay to work. In addition, other secondary market investors such as pension funds and insurance companies would need to accept the idea of paying premiums for mortgages. They are unlikely to be willing to face any possible losses and, therefore, would probably want large prepayment penalties also. In any case, the details of the relationship of lender-pay to secondary investors would have to be worked out in some detail and coordinated by the organized secondary markets where general practices are usually determined.

The effect on mortgage bankers of a lender-pay plan has received some attention and analysis already.[2] Unlike depository institutions such as savings and loan associations and banks, mortgage bankers do not, for the most part, hold mortgages in a portfolio. They operate as brokers between final investors and home buyers. In most cases, they do not make loans unless investors have made commitments.

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[1] Prepayment penalties are now forbidden on loans sold to the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association.

[2] Op. cit., Warner, pp. 22-23.

Since mortgage bankers operate with few funds of their own, the fear is that if they had to pay settlement costs without a pass-through to the borrower, many mortgage bankers might have to substantially constrain their business or even leave the market. Certainly, such a situation would be a problem if the final investors were not paying premiums for the mortgages. However, if advance agreements are reached by which mortgage bankers, or any primary lenders, are reimbursed for settlement expenditures, the problem should not be insurmountable. Further, additional service fees might be used to pay for settlement services. In essence the mortgage banker would be getting the fee for settlement services.

The concept of final investor financing of settlement charges is of significant relevance. In the last few decades, many of the services required by lenders actually have been a response to secondary market requirements.[1] This is particularly true for title insurance and conventional mortgage insurance. Mortgages sold on the secondary markets must have the standard ALTA lender's policy, not an attorney's opinion. Loans with high loan-to-value ratios which are not insured by the Federal government must be covered by mortgage insurance. Thus primary lenders who are not investors, cannot decide what level of protective services is necessary for all loans. The effect of necessary changes in secondary market operations to accommodate lender-pay should not be minimized. The disruption in the short run could be substantial. Large-scale investors have only recently been attracted to mortgage investments which have been standardized as a result of the requirements of secondary markets. The introduction of uncertainty due to premiums could act as a deterrent to some investors.

Finally, one of the major disadvantages of an interest-rate-plan is the overwhelming lender resistance. Lenders, including mortgage bankers, commercial banks, and savings and loan associations, fear that lender-pay would be defined as the lender rather than the home buyer paying the costs. In our interviews with lenders, trade associations, and regulatory agencies this fear was frequently expressed. Much of the fear is due to the idea of an interest-rate-only charge, which could lead to unprofitable lender investment in settlement services. Unless these fears are allayed, the lending industry would undoubtedly resist the idea of lender-pay.

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[1] See John C. Payne, "Closing Costs and the Mortgagee," Federal National Mortgage Association, General Counsel's Conference, (Savannah, Georgia, 1979).

Up-Front Fee

Another variation of lender-pay would allow lenders to charge one lump-sum fee at the time of the loan which would include points, origination fees, and other finance-related charges plus settlement services. Lenders would still arrange and pay for settlement services. Thus, they could negotiate for the best terms possible, reduce requirements if they desired, and compete for customers. Settlement services would be packaged and not sold separately as they now are. However, consumers would pay for the services directly rather than indirectly through the interest rate.

> Advantages. This plan avoids many of the problems of the interest-rate plan. Primary lenders would not need to invest in settlement services. Therefore, there would be no need for secondary market investors to pay a premium, nor would any prepayment structure be necessary to cover the cost of settlement expenditures.
>
> There would be no subsidy from short-term mortgages to long-term mortgages, nor would there be any distortion of interest rates. Thus FHA, VA, and usury ceilings would not need to be adjusted to accommodate settlement charges.
>
> No major changes in the timing of the payment would be necessary. The changes would result from the lender's assuming responsibility for arranging all settlement services. Because lenders would be acting as an intermediary for the services, they would presumably have an incentive to keep expenditures as low as possible.
>
> Further, the consumer would have only two prices to consider: the up-front charge and the interest rate. While this is more complicated than an interest-only plan, it is much superior to the present system in which consumers are faced with a multitude of prices. Lenders would be encouraged to compete to keep prices low on the up-front costs as well as on the interest rate. Further, if some home buyers preferred to pay up front and have lower monthly payments and others preferred higher payments, they could shop for the combination that suited their individual needs. The concept of lenders competing for borrowers by offering the least expensive package of settlement services would not change.
>
> Disadvantages. Because up-front charges would still exist, opportunities for owning a home would not be expanded by reducing the need for additional funds at closing. However, if lenders could reduce settlement costs, the total amount needed could be lowered. Also, monthly costs, which can act as a barrier to home ownership, would be diminished as compared to the inclusion in the interest rate option.

A more important disadvantage, however, is that lenders may not have as much incentive to keep prices down as they would under an interest-only plan. They may view their position as arranging for services rather than paying for them. However, if borrowers actually shop, lenders should have an incentive to keep their package cost as low as possible.

Settlement Service Loan

Lender pay could also be structured so that loans would be available to cover the charges for settlement services. The loan could either be an increase in the amount of the mortgage or a separate shorter term personal loan. These two different types of loan plans will be discussed under one plan because many of the advantages and disadvantages of the two plans are identical.

Advantages. If consumers borrow the amount of the settlement charges, their indebtedness rises. However, there is no distortion in interest rates as there is under an interest-only plan, and no up-front funds are necessary, as they are with the up-front fee. In the case of the personal loan, the term could be tailored to the individual, for example, five to ten years. Such a loan could be treated as any personal loan and need not necessarily be tied to the property involved. None of the problems with the secondary market that were discussed for the interest rate would exist. However, the concept of lender packaging of settlement services would continue. Borrowers could shop among lenders to find the lowest package cost and the best loan terms.

Disadvantages. Each of the loan plans has disadvantages that do not exist for the other types of payment structures. If settlement charges are added to the amount of the mortgage, the loan-to-value ratio could become extremely high and in some cases be greater than one. Even if it were not that high, some loans might require an increased amount of conventional mortgage insurance under such a plan in addition to the interest cost borne by one borrower. The additional cost might outweigh the savings from the packaged settlement costs. A personal loan would not distort the loan-to-value ratio of the mortgage. However, because it would undoubtedly be for a shorter period of time and at a higher interest rate, such a loan could significantly increase monthly payments. Many consumers might not want such payment burdens and, in fact, may not qualify if their income is not sufficient.

The lender is also at a disadvantage because an investment of his funds is still needed to cover settlement costs as it would be under the interest-only plan thus, funds for mortgages would be reduced. Although increasing the mortgage amount would not necessarily be a problem even on the secondary market, the primary lender would receive the full amount of his investment covering both the mortgage and the cost of settlement service.[1] As in the interest rate case, a prepayment penalty would be necessary.

With the short-term personal loan, the obstacle is more severe, especially for mortgage bankers. Unless mortgagees could arrange loans from other lenders, a substantial investment in settlement cost loans might have to be made. Even with depository institutions, if the loan is not sold on the secondary market, lenders might find themselves investing in settlement services.

EVALUATION

In a lender-pay plan the borrower ultimately pays for the settlement services on the house he buys, whether he pays for them in higher interest rates, at the time of the purchase, or through an increased loan amount. There are advantages and disadvantages to each plan.

The interest-rate plan has the advantage of simplicity. However, to implement such a plan would require the cooperation of not only the financial institution regulatory agencies, but the secondary markets as well. Such cooperation could be difficult. It also requires lender investment in settlement services, which might not be aceptable to many lenders, primary or secondary.

A loan to the borrower in the amount of the settlement charges would not distort interest rates. However, unless the loan was separated from the home loan, the loan-to-value ratio of the home mortgage could rise above acceptable levels. In either case, a lender would invest some of his funds in settlement services rather than mortgages, as in the case of the interest-rate plan.

The up-front fee would be the simplest plan to implement and would be most effective for consumers. Lenders would arrange for a package of settlement services but would not pay for it from their own funds. The secondary markets would not be required to accommodate any rules or changes in the system. There would be no changes in the interest rate or the loan-to-value ratio. A possible disadvantage to this plan is that lenders might not feel the necessity of keeping costs as low as they would if they were actually paying for the services and being compensated over a longer period of time. However, if consumers do shop, lenders would still be under competitive pressure to keep their package costs as low as possible. Another disadvantage is that, relative to the first option, up-front costs are higher and this might act as a barrier to home ownership for some potential buyers.[1] Also this problem may be ameliorated by allowing or encouraging lenders to consider making additional loans to cover the settlement costs.

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[1] The loan-to-value ratio would, however, be higher than for a conventional mortgage.

Lender-pay proposals do not mention the role of state regulation of lines of insurance. Compelling lenders to engage in packaging settlement services with the expectation that they would negotiate lower charges with underwriters is inconsistent with most state regulatory practices vis-a-vis title and mortgage insurance, under which a single premium rate is usually set. If state insurance regulatory practices are not changed, this factor alone may weaken the effect of lender pay in significantly reducing settlement charges. Consequently enactment of lender-pay without counterpart rationalization of state regulation of title and mortgage insurance would seem to be of only minimal value.

PROBABILITY OF A SAVINGS IN SETTLEMENT COSTS THROUGH LENDER-PAY

Whichever method of payment was used, lender-pay would be a success only if the total charges for settlement services to the consumer were lowered. At the beginning of this chapter, the conditions which would have to occur for this to happen were stated:

- a reduction in number of required services and/or;
- a reduction in costs of these services; and
- a pass-through of any savings by the lender to the consumer.

The probability that either of the first two of these conditions will occur should be discussed in terms of individual settlement services. Settlement costs consists of a number of different services, and unless the provision of these individual services is altered, total costs cannot be lowered.

In addition to the cost factor it is assumed that lender-pay would simplify shopping for settlement services and reduce its time and its cost. It would also obviate the need for many of the policy interventions described in this report, which are intended to better inform the consumer, increase shopping behavior, and reduce the incidence and remove the consequences of reverse competition.

Alternative Methods of Lowering Individual Costs

Costs can be lowered in one of several ways. One way is to not require the service. This might happen if lenders were to decide that the benefits of a particular service were not worth the cost of having the service performed. This type of decision might happen in the case of appraisals, surveys, or credit checks. While all of these services may be necessary for certain transactions, lenders could decide to use them on a discretionary basis rather than require them for every single loan, as is often the case at the present time. This change would not be unreasonable, especially for the homes in new subdivisions or areas in which lenders have had recent transactions

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[1] Recall our comment that higher monthly charges may for many be a greater barrier to home ownership for many buyers than higher up-front costs.

Another method by which lenders might be able to lower costs is better negotiation with outside providers of these settlement services. Presumably, lenders have several advantages over individual home buyers. They could buy services for more than one transaction at a time. Therefore, they might be able to receive "quantity discounts." In addition, they are more knowledgeable and might be able to negotiate lower prices or more efficient forms of the service required. This occurence is most likely in the areas of title assurance and conveyancing services. Lenders who presently require the use of a specific attorney who charges noncompetitive prices may decide to negotiate lower rates or not require attorney involvement in the settlement process but have title insurance companies perform most of the services. Alternatively, lenders might urge lower prices for title assurance through the use of a single policy, more efficient operations, or a discount for subdivision properties.

When lenders were asked whether they believed competition would increase resulting in lower settlement costs under a lender-pay plan, 55 percent responded that they thought this would occur over all. When asked whether they believed that they could negotiate lower charges for specific services, the following percentage of lenders answered yes:

• Title search	34%
• Title assurance	30%
• Mortgage insurance	17%
• Survey	33%
• Appraisals	39%
• Credit report	16%
• Legal services	35%

Thus, while the majority of lenders do not believe they could lower prices for any specific settlement service, a significant portion felt that prices for some of the settlement services could decline. All of these figures could be understated if lenders find lender-pay to be unattractive.

Another method by which lenders could lower costs is by having some of the tasks performed in-house by their own personnel rather than by other providers. Clearly this option is more meaningful for large lenders than for smaller ones.

In fact, one of the most common criticism of lender-pay is that as a system it would work against small lenders and add to the forces acting in the direction of greater consolidation in the industry.

Probability of Pass-Through of Savings to Consumers

There seems little doubt that lenders could obtain lower costs for most settlement services than home buyers. Large scale purchasing and negotiation for better terms and prices is clearly feasible for lenders in most localities. But whether lenders will, in fact, act aggressively to lower settlement costs and whether the resultant savings will be passed on to the consumers will likely depend on whether they are under intense pressure from competitive market forces to do so.

The extent of active price competition in the market for mortgage lending was described in Chapter X. After reviewing data on the extent of price variation among providers and other factors that are relevant for an evaluation of market performance, we concluded that the evidence from the numerous criteria suggests that workable or active price competition does exist to a reasonable extent in mortgage lending markets in the large urban markets.[1] Whether price competition is sufficiently robust to pressure lenders into both arranging for settlement services at lower than prevailing costs and passing those savings on to consumers cannot be determined. As noted earlier, were the packaging of settlement services capable of providing lenders with competitive advantages, they would undoubtedly engage in such activity voluntarily. Lenders in most places arrange for at least some services such as appraisals and credit reports. They also arrange for mortgage insurance. Our study of this industry indicates that lenders have not actively sought to negotiate for lower mortgage insurance charges even though such charges possibly could be used as a competitive tool.

In summary, there is no clear indication that lenders would be under sufficient competitive pressure under a lender-pay plan to offer settlement services at lower than prevailing costs in most areas. In some localities, settlement charges might even rise.

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[1] We arrive at this conclusion despite data from our survey indicating that most borrowers (65 percent) contacted only one lending institution in arranging for a mortgage.

EFFECT ON PROVIDER INDUSTRIES

The effect of lender-pay on some industries could be substantial. Since the disruption to present patterns might not be reversible at a later date, the potential changes should be analyzed if lender-pay is to be considered.

Major changes could probably be expected in the title assurance and conveyancing industries. Lender-pay would probably encourage the proliferation of title agencies[1] controlled by lenders. Many savings and loan associations already own title agencies through their service corporations. This trend could be expected to continue. Title companies would market exclusively through lenders and as a result, real estate brokers and attorneys would no longer be viable referrers. Attorneys who had tied relationships with lending institutions or who could offer services to receptive lenders at lower cost would be in a position to provide title assurance and conveyancing services. Other attorneys, however, may have little chance to become involved in real estate work except in special cases where home buyers felt they needed representation at settlement or assistance with the sales contract. Undoubtedly, lender groups would advocate the elimination of unauthorized practice of law rulings that require attorneys to perform routine settlement services. These efforts would undoubtedly be opposed by the state bar associations although the posture of the American Bar Association is much more positive on this point.

Other groups likely to be affected are appraisers and surveyors. Large lenders might either hire their own staff to perform these functions as needed or negotiate very low rates. Alternatively, they may decide not to require these services for everyone. It is difficult to predict how widespread such reactions among lenders would actually be. At the present time the demand for these services is controlled by lenders. They may not desire to make any changes in the present situation, even under lender-pay.

The industry least likely to be affected structurally is the private mortgage insurance industry. The demand for this product is determined by secondary market regulations and the Federal Home Loan Bank Board requirements. Individual lenders are not likely to be in a position to make decisions on the requirement for mortgage insurance and the coverage.

It appears that tile insurance companies and attorneys would be most affected by lender-pay.

IMPLEMENTATION POSSIBILITIES

The plan originally proposed by Professor Whitman assumed that, if implemented, lender-pay would be mandated for all lenders nationwide. Such a national policy would include both state and nationally chartered mortgage lenders. If lender-pay is considered a worthwhile enterprise, it might be useful to pilot test the concept in a few selected sites to determine the effects on consumers, lenders, and settlement service industries.

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[1] Not title insurance underwriters.

Nationwide Implementation

If lender-pay were to be adopted, nationwide implementation would have the advantage of affecting all lenders simultaneously. Market investors would not be able to select only those mortgages which were not under a lender-pay plan. Further, settlement service providers could not avoid the plan by refusing to operate in certain areas. All investors and providers would have to adjust their operations to the lender-pay plan though they would not under a selected site plan.

The disadvantage of nationwide implementation is that if lender-pay does not lower charges or has substantial adverse impacts on either lenders or settlement service industries without a reduction in charges to consumers, the result could be both harmful and irreversible. Once the plan is implemented, rescision could be difficult, if not impossible. Relationships would have been broken and new patterns of business established. For example, many lenders may establish their own title insurance agencies to write policies on the loans they make. It is likely that even if lender-pay were later dropped as a requirement the lending institutions would continue to operate these agencies, especially if they proved to be profitable. Thus nationwide implementation would probably not be reversible.

If settlement costs are important to home owners and shopping occurs under lender-pay, the settlement charges should not rise. However, lender-pay will undoubtedly institutionalize controlled business and tied relationships. Unless the packaging of settlement services for one price leads to different perspectives among consumers and lenders alike, one potential outcome of lender-pay could be an increase in controlled business and possibly prices.

Pilot Test Implementation

An alternative to nationwide implementation is to have lenders in selected sites adopt the program. The federal financial institutions regulators could then monitor the results to determine whether the benefits warranted the introduction of the plan nationwide. The primary advantage would be that if prices did not fall or if other adverse effects occurred, the results would not be irreversible in terms of national industries. Further, if certain aspects of the program are found unfeasible, those features could be altered before the plan is implemented nationwide. In other words, regulators could determine what the best form of lender-pay is by receiving feedback from the pilot operation.

The disadvantages of this plan were mentioned as some of the benefits of a nationwide plan. Secondary markets and investors might discriminate against loans from those areas using a lender-pay plan. This is a real possiblity under an interest-only plan, where the loans would require a premium payment by secondary investors. Certainly the organized secondary markets would have to agree to cooperate in the purchase of these loans. With regular mortgages available from other areas, the probability is strong that private investors would avoid lender-pay loans unless the settlement charges had been paid up-front.

Further, providers of some settlement services might not operate in these areas if they felt that lender-pay would not be to their benefit. This could not occur in the case of locally provided services such as appraisals or surveys. However, major mortgage insurers and title insurers operate nationwide, and they could afford to boycott certain cities or states. Title insurers especially may feel that lender-owned agencies are such a threat that they would refuse to participate, especially in areas where they have strong relationships with brokers. While provider boycotts are a possibility, it is highly doubtful that without explicit illegal collusion, some providers would not be willing to provide services and increase their market share.

Another problem with selective implementation is that lenders in certain localities might not be willing to participate on such a basis. They may feel that they were being used as "guinea pigs" and that if the plan were later rescinded, the participating lenders would have lost time and money.

CONCLUSIONS

Lender-pay is an appealing idea in that responsibility for settlement costs would be placed on individuals who are informed and have contact with the real estate transfer business on a daily basis. Further, since many of the services which are demanded are in response to lender requirements, the responsibility would not be misplaced. Clearly lenders are in a better position to negotiate with settlement service providers of all kinds than are buyers, because of their knowledge and because they would be purchasing large amounts of services at one time to cover a number of loans. Home buyers would be relieved of both the responsibility and stress of shopping for numerous settlement services, many of which they do not understand.

In addition, lender-pay would simplify the chore of shopping for individual settlement services and reduce the time required for shopping and its cost.

However, a lender-pay plan could drastically alter patterns of provision of these services as they exist today. The interest-only plan would have a greater effect on the payment process and the secondary market than either the up-front payment or the additional loan plans. However, any plan would affect business relationships as they exist today.

Unless there is reasonable certainty that lender-pay will lower settlement charges and that no better mechanism is available to achieve this end, it should not be implemented on a national basis. This volume has analyzed many suggestions for changing and regulating the settlement service industries.

While marginal changes in individual settlement industries and in the process of providing relevant information to consumers are likely to lead to price reductions only over a period of time, they may be preferable to the total restructuring of the industries in a short period of time that would be caused by national implementation of lender-pay.

While we feel lenders are in a position to provide settlement services at lower than prevailing prices, we are uncertain whether there is reasonable certainty that competition in the market for lenders' services is sufficiently robust and consistent to motivate them into providing those services and passing the savings on to consumers. However, implementation of lender-pay, on a selected site or pilot test basis, could be justified by the potential for cost reductions under the plan. If such a pilot program does not result in reduced charges to consumers in practice, the unnecessary disruption to the system from a nationwide implementation of lender-pay could be avoided.

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